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RECONSIDERATION OF UNITED STATES
OVERSEAS DIRECT
INVESTMENT CONTROLS

Robert Joseph O'Shaughnessy

RECONSIDERATION OF UNITED STATES OVERSEAS DIRECT INVESTMENT CONTROLS

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A Thesis Submitted to the School of Government and Business Administration of The George Washington University in Partial Fulfillment of the Requirements for the Degree of Master of Business Administration

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CHAPTER I

INTRODUCTION

At the end of World War II, through large public and private capital outflows for reconstruction and development, the United States supplied the world with dollars and consequently international liquidity. The substantial reduction of our import barriers and our low interest rate was not matched by other countries. Our military aid and the deployment of armed forces abroad added additional dollars to foreign balances. In order to bring about an international balance in trade, many leading currencies were devalued substantially relative to the dollar, and the dollar appreciated. All these policies and programs eventually resulted in U.S. balance of payments[1] deficits which were initially welcomed abroad as they allowed countries to replenish their international reserves and eventually return to currency convertibility.[2]

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[1]The balance of payments is defined as a statistical record of economic transactions between residents of the United States and residents of the rest of the world. The measurement is in terms of dollars and in terms of fixed time periods during which the transactions take place. U.S., Department of Commerce, Dictionary of Economic and Statistical Terms (Washington, D.C.: Government Printing Office, 1969), p. 23.

[2]U.S., Congress, Joint Economic Committee, Joint Economic Report 1965, 89th Cong., 1st sess., 1965, p. 11.

The Committee for Economic Development summarizes events after 1958 with this statement:

> By 1958 the so-called "dollar shortage" had disappeared. Nonetheless continued United States expenditures to support peace, economic deployment, and political stability around the world, and the reappearance of extensive foreign borrowing in New York, combined to produce continuing and larger balance-of-payments deficits. The Western European nations, for their part, had largely regained sufficient economic strength to want to reassume a position of greater equality and influence with the United States in the world. In subsequent years, the door was opened for gold conversions to be used as a means of exerting economic and political pressure on the United States.[1]

As this statement suggests, it is imperative that the United States solve its balance of payments problem in order to maintain the financial, economic, political, and military leadership of the free world. A simple solution for eliminating the chronic deficit would appear to be for the United States either to cut overseas expenditures or increase revenues from foreign countries by the amount of the deficit. While the solution appears basically simple, political, military, and other economic considerations have precluded the reduction of overseas expenditures. Also, complicating a resolution of this problem are the many factors, both visible and invisible, which influence or contribute to a surplus or a deficit in the U.S. balance of payments, i.e., exports, imports, military expenditures overseas, AID, loans, and so on. In addition, changes in

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[1]U.S., Committee for Economic Development, The Dollar and the World Monetary System (New York, 1966), p. 31.

component accounts, reflects changing world conditions, and a major change in one account can cause unidentifiable and unpredictable indirect effects on other accounts in the balance of payments.

Cumulative deficit

Measured against a U.S. 1970 gross national product of 977 billion dollars,[1] a deficit of two to five billion dollars in the balance of payments account, on the liquidity basis, would not appear to be a matter of immediate or appreciable concern. However, the United States has had a continuous liquidity deficit since 1950 except for 1957 and 1968. For the period 1950-1970, the United States has had a total cumulative international payments liquidity deficit of 48.7 billion dollars.[2] This cumulative deficit has considerably weakened the dollar in the international markets and eyes of the world. Consequently, our international creditors may, from time to time, feel that they are holding more dollars than they want, and international confidence in the dollar is further eroded.

The degeneration of the United States liquidity position in the sixties, resulting from a continuous

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[1] Economic Report of the President, transmitted to the Congress February, 1971, together with The Annual Report of the Council of Economic Advisers (Washington, D.C.: Government Printing Office, 1971), p. 197.

[2] Computation for the period 1950-70 is from the international statistical tables in The Annual Report of the Council of Economic Advisers, 1971, p. 299.

persistent deficit in the balance of payments, can be illustrated by comparing U.S. liquidity ratios during this period:

Liquidity Ratios

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969
U.S. Reserves all liquid liabilities	.90	.80	.72	.64	.57	.53	.50	.45	.47	.40

Source: Survey of Current Business, October, 1970, p. 25.

Statement and Importance of the Problem

The adverse movement of the U.S. liquidity position from 0.9 to 0.4 in ten years points out the seriousness and ultimate consequences of a sustained deficit. Because of this continuous deficit in the United States balance of payments, a crisis of confidence in the monetary system developed in November, 1967. The devaluation of the British pound in November was quickly followed by a sharp reduction in U.S. gold stock. The U.S. balance of payments deficit in 1967 rose to $3.6 billion with the fourth quarter running at an annual rate of over $7 billion.[1]

In an attempt to restore international confidence in the dollar through balancing or creating a surplus in the

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[1] Computation of the annual rate is based on the fourth quarter statistical data appearing in U.S., Department of Commerce, "U.S. Balance of Payments and Reserve Position," Survey of Current Business, June, 1968, p. 36.

United States balance of payments, President Johnson, in a statement outlining a program of action on January 1, 1968, imposed direct controls on United States private overseas investments.[1]

Disagreement on investment controls

The Joint Economic Committee of the Congress of the United States, in its 1968 economic report, expressed considerable concern over the seriousness of the U.S. balance of payments deficit and the controls imposed on private U.S. overseas investments:

> The result of our worsening payments position has been an erosion of world confidence in the dollar. Foreign dollar holders are now anxiously waiting to determine whether the United States will at long last exercise financial responsibility at home. In the meantime, any one of a number of possible economic or political developments could trigger a run on gold that might well destroy the international monetary system as we know it today. The shock would set back the growth and prosperity of the free world for years to come.
>
> Under these circumstances, rebuilding world confidence in the dollar must be regarded as the first objective of economic policy in 1968. Above all, we must provide an affirmative answer to the questions that increasingly are being asked abroad about our ability--and our willingness--to take those actions needed to restore balanced and healthy growth to our domestic economy.
>
> The Administration's Balance-of-Payments Program
>
> The Johnson administration's response to the dollar crisis is a program of shortsighted and self-defeating controls. The administration has swallowed the utterly

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[1]Lyndon B. Johnson, "Balance of Payments," Speech Delivered January 1, 1968, in Weekly Compilation of Presidential Documents, IV (January 8, 1968), 23.

mistaken notion that the dollar can be strengthened by limiting its usefulness.[1]

Research Question

There was and still is unanimous agreement on the need for the United States to bring its international accounts into equilibrium. However, there is disagreement on the methodology for accomplishing the correction of the fundamental imbalance. President Johnson decided that direct controls on funds flowing into foreign investments was the answer. The Joint Economic Committee disagreed. Accordingly, the basic question to be investigated in this study is whether or not United States Government controls on the movement of private capital abroad have contributed to improving the United States balance of payments position or whether such controls, in reality, will eventually lead to a further weakening of the dollar and the United States leadership of the free world. If mandatory controls have contributed measurably to the improvement of the U.S. balance of payments position, then they should be maintained. If, in fact, they do not, then do they jeopardize future investment earnings and repatriation of investment income?

Purpose

The purpose of this study is to document and examine these restrictions on private overseas investments in order

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[1] U.S., Congress, Joint Economic Committee, Joint Economic Report 1968, 90th Cong., 2d sess., 1968, p. 71.

to determine if the United States should reevaluate or reconsider private investment controls and restrictions. Hopefully, the study will point out the utility or disutility of these restrictions and also serve as a recapitulation of the United States overseas private investment position.

Scope and Limitations

The balance of payments is more than a statistical statement of a country's annual international transactions. It is used as an analytical tool to point out significant data and trends which affect the international stature of a nation and to isolate any potential problem areas. While the balance of payments consist of a multitude of transactions, this study will primarily focus and concern itself with only a small part of those transactions which belong to the capital account and the U.S. restrictions affecting that account. For clarification purposes, certain functional groupings and transactions in the balance of payments must be identified.

Functional classifications

Data are grouped into functional and subfunctional classifications in addition to a debit or credit classification.[1] The main functional classifications as shown in

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[1]Appendix I is a reproduction of U.S. International Transactions in 1968 which shows the functional and subfunctional classifications and divisions of data. Major functional division definitions, as defined by the U.S. Department of Commerce Dictionary of Economic and Statistical Terms, are also included.

tables by the Department of Commerce are:

1. Balance of goods, services, and unilateral transfers. It "represents the balance on current account which--except for errors and omissions--must be counterbalanced by capital movements, a change in official reserves or both."[1] This account includes such items as exports and imports, travel, military expenditures, transportation, U.S. government grants and pensions, income on government and private investments abroad, and income on foreign investments in the United States.

2. Transactions in U.S. private assets, net. This is sometimes referred to as the capital account. Such transactions record the acquisitions and sales by U.S. private residents of assets outside the United States. Four subfunctional classifications or categories of transactions within this grouping are direct investments abroad, purchases of foreign securities, bank claims on foreigners and private claims, other than direct investments, on foreigners.[2]

3. Transactions in U.S. Government assets, excluding reserve assets, include loans, credits, aid and subscriptions to foreign nations by the U.S. Government.[3]

4. Transactions in U.S. official reserve assets include changes in the U.S. gold reserve, convertible foreign

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[1]Department of Commerce, Dictionary, p. 35.

[2]*Ibid.*, p. 36.

[3]*Ibid.*, p. 38.

currencies and the tranche position in the International Monetary Fund (IMF).[1]

5. Transactions in foreign assets in the United States include foreign private and official acquisitions and sales of U.S. assets. These transactions are divided into four subfunctional divisions or categories of foreign direct investment in the United States, purchases and sales of U.S. securities, long-term deposits by foreigners, and foreign purchases of U.S. notes and money market instruments.[2]

6. Net errors and omissions. This is the statistical discrepancy between total recorded entries under receipts and total recorded entries under payments. It is entered as either net receipts or net payments, as needed in order to fulfill the accounting principle that the sum of the receipts and payments must balance. The source of the discrepancy cannot be identified with any precision.[3]

Balance on the liquidity basis

It must be remembered that the balance of payments reflects a current position for a given period of time and does not reflect the total U.S. assets or liabilities overseas. It can be thought of as a current income/expenditure account with the rest of the world. The United States uses

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[1] *Ibid.*, p. 39.

[2] *Ibid.*, p. 41.

[3] *Ibid.*, p. 43.

both the liquidity basis and the official reserve transactions basis to measure its overall current balance. The liquidity basis measures the outflow and inflow of monetary assets or items which can be freely converted into money with a minimum risk of changes in the market value. Included in this basis are all reported short-term private and bank liabilities to foreigners and foreign holdings of all U.S. Government marketable securities. The overall balance on the liquidity basis is equal to "changes in liquid liabilities to foreign official holders, changes in liabilities to other foreign holders, and changes in official reserve assets consisting of gold, Special Drawing Rights, convertible currencies, and the U.S. gold tranche position in the IMF."[1]

Balance on official transactions basis

The overall balance on the official reserve transactions basis measures official settlements in the balance of payments. The overall balance on this basis is equal to changes in liquid and nonliquid liabilities (marketable securities) to foreign official holders and changes in official reserve assets consisting of gold, Special Drawing Rights, convertible currencies, and the U.S. gold tranche position in the IMF.[2] The significant difference between the

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[1]*The Annual Report of the Council of Economic Advisers*, 1971, p. 299.

[2]*Ibid*.

two is that the liquidity basis measures changes in both private and official liquid holdings while the official reserve transactions basis measures only differences in official holdings.

International role of the dollar

The balance measured on the liquidity basis, which will be used exclusively in this study, highlights the international role of the U.S. dollar as a vehicle for international private, commercial, and official settlements. A deficit in this account increases dollar holdings of foreign governments and private foreign residents. There is no urgency in a deficit as long as foreigners are willing to hold dollars as part of their reserves or as long as the U.S. reserve position is strong enough to ward off a run on the dollar.

Limitations

While the accounts within the balance of payments are never static, for purposes of this study they must be held relatively constant in order to examine the restrictions and usefulness of U.S. private investment restrictions abroad. Such a position also rules out a world calamity or catastrophe which would also distort any usefulness of this study in regard to improving our balance of payments position through a reconsideration of our investment restrictions. Of necessity, the study will primarily concern itself with the capital

accounts in the balance of payments with the main focus on the restrictions to direct investments overseas. For continuity purposes and clarification, other accounts and their effects will be touched on from time to time but the emphasis will remain on overseas private investment restrictions. Hopefully, these limitations will not inhibit or distort the usefulness of this study.

Methodology

Areas in which research has been accomplished for this study include U.S. Laws and Statutes, the *Congressional Record*, *Federal Reserve Bulletins*, *Vital Speeches of the Day*, Executive orders, and Congressional hearings. A considerable effort was made, where possible, to use only primary source material. In this respect, the post World War II period has been stressed as the area of significant interest, because after World War II, because of its industrial and commercial strength, the U.S. dollar was substituted for gold in settling international debts between foreign countries.

Department of Commerce officials responsible for insuring U.S. investor compliance with the direct investment controls were interviewed regarding the effectiveness of these controls. While candid in some of their remarks, they were not responsive to direct questioning and refused to be quoted or identified in any way.

Organization of the Study

This paper is organized to reflect recent U.S. Government private investment restrictions as a means of restoring an equilibrium in the U.S. balance of payments. First, U.S. investment restrictions are documented. Second, the private international investment position of the United States is reviewed. In the fourth chapter, some observations on the effects of U.S. Government manipulations to restore the balance through investment controls are made. Prior to concluding remarks, an alternative to capital investment controls is presented.

CHAPTER II

HISTORICAL REVIEW OF UNITED STATES INVESTMENT CONTROLS

Imposition of direct controls on private U.S. overseas investments on January 1, 1968, by President Johnson was an unprecedented action in United States financial history. It was the first time that mandatory controls had been placed on U.S. private investments abroad. In imposing the controls, President Johnson said:

> To the average citizen, the balance of payments, and the strength of the dollar and of the international monetary system, are meaningless phrases. They seem to have little relevance to our daily lives. Yet their consequences touch us all--consumer and captain of industry, worker, farmer, and financier.[1]

The President further emphasized that the economies of all nations, rich and poor, are tied together through world trade and finance. If any country faltered in its economic relationships with other countries, it would have a direct or indirect effect on the prosperity of U.S. citizens. He reminded Americans that the health of the world monetary system and world trade, and consequently their own prosperity, depended upon the health of the American dollar which was

[1] Lyndon B. Johnson, "Balance of Payments," Speech Delivered January 1, 1968, in Weekly Compilation of Presidential Documents, IV (January 8, 1968), 20.

used as an international currency.[1] He stressed this point by saying:

> We cannot tolerate a deficit that could threaten the stability of the international monetary system--of which the U.S. dollar is the bulwark.
>
> We cannot tolerate a deficit that would endanger the strength of the entire free world economy, and thereby threaten our unprecedented prosperity at home.[2]

President Johnson's action culminated previous measures to reduce the chronic deficit. Since 1959, three Presidents--President Eisenhower, President Kennedy, and President Johnson--had taken various measures to establish an equilibrium in the U.S. balance of payments.

Early Control Measures 1959-1964

Buy American

The first dramatic step was the "Buy American" principle to the financing of loans and grants by the Development Loan Fund in October 1959. At that time, very few leading U.S. citizens considered the balance of payments deficits as a very serious threat to the international stability of the dollar. The U.S. military assistance program was not affected as the Mutual Security Program was already buying 75 per cent of all economic assistance from U.S. sources.[3]

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[1] *Ibid.* [2] *Ibid.*, p. 23.

[3] William H. Draper, "Gold Reserve, the Dollar, and Foreign Aid," remarks delivered before the Overseas Press Club, November 19, 1959, *Vital Speeches of the Day*, XXVI, 165.

President Eisenhower

The seriousness of the problem was vividly expressed on November 16, 1960, when President Eisenhower issued a directive to reduce and limit the number of U.S. military and civilian dependents abroad to a total of not more than 200,000 at any one time and ordered military expenditures abroad to be reduced both from appropriated and nonappropriated funds. Other government agencies were also directed to reduce their overseas expenditures and buy goods and services of U.S. origin.[1]

President Kennedy

President Kennedy, on February 6, 1961, rescinded the unpopular limitations on U.S. dependents overseas, recommending instead: the sale of newer weapons and weapons systems to our allies; reduction of the customs exemption for returning Americans from $500 to $100 on a wholesale basis; promotion of exports; a program to encourage the maintenance of foreign deposits in the United States; encouragement of foreign travel to the United States; legislation "to prevent the abuse of foreign tax havens by American capital abroad."[2]

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[1] Dwight D. Eisenhower, "International Balance of Payments," Statement and directive released at Augusta, Georgia, November 16, 1960, Vital Speeches of the Day, XXVII, 98.

[2] John F. Kennedy, "U.S. Balance of Payments and the Gold Outflow from the United States," Message on February 6, 1961, to House of Representatives, 87th Cong., 1st sess., Doc. No. 84, Congressional Record, CVII, 1791.

The tariff act of 1930 was amended on August 10, 1961, and reduced temporarily the duty exemption for returning U.S. residents from $500 to $100.[1] The next year, on October 16, 1962, legislation to remove any tax havens in foreign investments was signed.[2] However, these measures did not stem the tide and the seriousness of the problem was reemphasized when President Kennedy, on July 18, 1963, called for a reduction in military expenditures overseas and a more vigorous effort in expanding our exports and increasing the number of foreign visitors to the United States.[3]

Interest Equalization Tax

To stem the outflow of private U.S. capital, President Kennedy supported an increase in short-term interest rates and recommended a tax on foreign securities sold in the United States--the Interest Equalization Tax (IET), which would increase the interest cost to foreigners of obtaining capital in this country through the sale of securities.[4] The tax would be graduated "from 2.75 per cent

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[1]U.S., Statutes at Large, LXXV, Pub. L. 87-132, 87th Cong. (1961), 335.

[2]U.S., Revenue Act of 1962, Statutes at Large, LXXVI, Pub. L. 87-834, 87th Cong. (1963), 960-1069.

[3]John F. Kennedy, "Balance of Payments," Message to House of Representatives on July 18, 1963, 88th Cong., 1st sess., Doc. No. 41, Congressional Record, CIX, 12940-44.

[4]Ibid.

to 15 per cent of the value of debt obligations" depending upon the maturity date. This would increase the overall cost of the issue by approximately 1 per cent.[1] On September 2, 1964, the Interest Equalization Tax Act was passed which imposed a tax on foreign securities sold in the United States.[2] The law was retroactive generally to July 18, 1963.

President Johnson's Control Efforts 1965-1968

President Johnson, in a special message on the U.S. balance of payments on February 10, 1965, requested an extension of the Interest Equalization Tax Act for two years beyond December 31, 1965, an increase in the tax coverage to nonbank credit of one to three-year maturities, new legislation to exempt from antitrust laws "voluntary cooperation" by banks in limiting their lending abroad, legislation to further reduce duty-free exemptions of returning American tourists to $50 on a retail price basis, and new tax legislation to increase the incentives for foreigners to invest in U.S. corporate securities.[3]

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[1] Ibid.

[2] U.S., Interest Equalization Tax Act, Statutes at Large, LXXVIII, Public Law 88-563, 88th Cong (1965), 809-47.

[3] Lyndon B. Johnson, "Reviewing the International Balance of Payments and Gold Position," Message to House of Representatives, February 10, 1965, Congressional Record, 89th Cong., 1st sess., Doc. No. 83, CXI, 2468-71.

Voluntary bank restrictions

Under the authority of the Gore amendment, the President extended the interest equalization tax to bank loans of one year or more and requested the banking community to limit foreign lending to 105 per cent of the level of loans to foreigners as of December 31, 1964.[1] Assurance had been received from the Canadian Government that they would limit the volume of new security issues sold in the United States "to the maintenance of a stable level of Canada's foreign exchange reserves."[2]

Other measures in 1965

The Secretary of Defense, Agency of International Development (AID), and others had been directed by the President to "cut their overseas dollar costs to the bone."[3] Since 85 per cent of new AID commitments at this time were spent in the United States, very little foreign exchange costs could be saved under AID programs. However, the Secretary of Defense was specifically directed to shift defense buying from sources abroad to sources in the United States, reduce staffs overseas, streamline support operations overseas, and work with defense partners to increase their offset purchases of U.S. military equipment.[4]

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[1] *Ibid.* [2] *Ibid.*

[3] *Ibid.* [4] *Ibid.*

In addition to all of these measures, the President asked for the support of American business leaders in limiting their direct investments abroad.[1] President Johnson also called for promotion of U.S. exports and announced a program of "See the U.S.A." in order to increase tourism to the United States and encourage U.S. citizens to see their own country rather than travel abroad.[2]

On June 30, 1965, Congress declined to reduce further the duty-free exemption from $100 to $50.[3] However, the exemption was altered from a wholesale to a retail price basis.[4] The amount of duty-free liquor which returning American tourists could bring back to the United States was also reduced from one gallon to one quart.[5]

New legislation was enacted in 1965 which exempted the banking community from antitrust laws when the banking community cooperated with each other in limiting their foreign loans. The legislation was for a period of twenty months.[6] On October 9, 1965, the new interest equalization

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[1] Ibid. [2] Ibid.

[3] "Exemption from Duty for Returning Residents," Congressional Record, 89th Cong., 1st sess., June 30, 1965, CXI, 15264-65.

[4] U.S., Statutes at Large, LXXIX, Pub. L. 89-62, 89th Cong. (1966), 208.

[5] Ibid.

[6] U.S., Statutes at Large, LXXIX, Pub. L. 89-175, 89th Cong. (1966), 672-74.

tax measures requested by the President were enacted into legislation and the IET was extended to July 31, 1967.[1]

Voluntary direct investment controls

Despite all these measures, the deficit in the balance of payments continued in 1965. Accordingly, in a letter to Secretary Henry H. Fowler on December 2, 1965, which approved new recommendations of the Cabinet Committee on the balance of payments, President Johnson wrote: "It is private outflow that has grown so sharply in recent years, some further reduction is necessary if we are to solve this problem without crippling our economy at home or compromising our leadership abroad."[2] The President concluded the letter by stating:

> The government will continue to do its part. Since 1960, Secretary McNamara has reduced the balance of payments cost of military spending abroad by about 40 per cent--despite the increase in spending on Viet Nam. Administrator Bell has reduced the balance of payments impact of foreign assistance by 50 per cent.[3]

Balance of payments recommendations for 1966, which were approved by the President's letter to Secretary Fowler, were designed essentially to stem the flow of private capital abroad. Summarized, these recommendations were:

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[1]U.S., Interest Equalization Tax Extension Act of 1965, Statutes at Large, LXXIX, Pub. L. 89-243, 89th Cong. (1966), 954-66.

[2]Letter from President Johnson to Secretary Fowler dated December 2, 1965, released December 5, 1965, Weekly Compilation of Presidential Documents, I, No. 20, 559-60.

[3]Ibid.

1. Corporations, on a voluntary basis, limit direct investments during the two year period 1965-1966 to 90 per cent of the amount invested during the three year period 1962-1964. For this purpose direct investments were defined to include capital outflows and reinvested earnings of U.S. subsidiaries abroad.

2. Bank and non-bank ceiling for loans be raised from 105 per cent of the 1964 base in stages of 1 per cent per quarter to a new ceiling of 109 per cent in the final quarter of 1966.[1]

Other measures in 1966

Other recommendations approved were: to continue the exemption of Canada from the interest equalization tax;[2] that all government agencies reduce to a minimum the balance of payments impact of their operations; that legislation be enacted to encourage foreign investment in the United States; that foreign and domestic tourism in the United States be promoted; to "step up" efforts by government and private

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[1]"Balance of Payments," Summary of recommendations by the Cabinet Committee on balance of payments dated December 3, 1965, released December 5, 1965, Weekly Compilation of Presidential Documents, I, No. 20, 560.

[2]About one-third of net capital market financing in Canada is derived from United States sources. Historically, the deficit in the Canadian current account was covered by large inflows of long-term capital from the United States through the flotation of securities. This pattern was upset by the interest equalization tax, which increased the cost of these securities to American buyers. To avoid a major disruption to the Canadian economy, Canada was exempted from the major features of the tax. Andrew F. Brimmer, Board of Governors of the Federal Reserve, "United States-Canadian Balance of Payments Prospects and Opportunities," Remarks delivered before the First National Conference of Canadian Bankers, Chateau Champlain, Montreal, Quebec, September 28, 1970.

enterprise to expand U.S. exports.[1] While the balance of payments was not mentioned, it is interesting to note that the discount rate was also increased on December 5, 1965.[2]

The use of reserved foreign currencies in lieu of dollars for current expenditures was authorized on October 15, 1966.[3] Also, in November, legislation called the Foreign Investors Tax Act of 1966 was enacted,[4] which was designed to induce foreign capital toward the United States and influence other countries in the merit of equal access to their own markets.

<u>1967 reviewed</u>

The deficit continued through 1966, and on January 26, 1967, President Johnson said that he was counting on the full cooperation of businesses and banks in their continued voluntary restraint program for corporate investments abroad and for foreign lending by financial institutions, and he recommended:

1. That Congress extend the Interest Equalization Tax to July 31, 1969 and requested authority to adjust the tax rate as monetary conditions warranted between zero and two per cent.

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[1] "Balance of Payments," Summary of recommendations by the Cabinet Committee, December 3, 1965, p. 560.

[2] Prime rate is the interest charged by banks to their best customers and fluctuates with the discount rate. Discount rate is the interest charged by the Federal Reserve on loans to member banks.

[3] U.S., <u>Statutes at Large</u>, LXXX, Pub. L. 89-677, 89th Cong. (1967), 955.

[4] U.S., <u>Foreign Investors Tax Act of 1966, Statutes at Large</u>, LXXX, Pub. L. 89-809, 89th Cong. (1967), 1539-59.

2. That a special task force be appointed to find ways to stimulate foreign travel in the United States.

3. That efforts be made to stimulate exports, attract more foreign investment to the United States, and encourage further development of foreign capital markets.

4. That he would request expansion, by $4.5 billion, of the lending authority of the Export-Import Bank and would continue to urge other countries to share more in the costs arising from common defense and foreign assistance.[1]

On July 31, 1967, the "Interest Equalization Tax Extension Act of 1967" was enacted; it extended the tax to July 31, 1969, and varied the tax as a percentage of actual value depending upon the period of maturity from 1.05 per cent to 22.5 per cent.[2] In August 1967, the authority for exemption from the banking antitrust laws to assist in safeguarding the balance of payments position of the United States was extended to June 30, 1969.[3]

<u>Mandatory direct investment controls ordered</u>

The deficit continued in 1967 and consequently, on January 1, 1968, President Johnson by Executive Order 11387 dated January 1, 1968:

1. Ordered that anyone, alone or together with affiliates, that acquires 10 per cent interest in the voting

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[1]Lyndon B. Johnson, <u>Economic Report of the President, Transmitted to Congress January 26, 1967</u> (Washington, D.C.: Government Printing Office, 1967), p. 14.

[2]U.S., <u>Interest Equalization Tax Extension Act of 1967</u>, Pub. L. 90-59, 90th Cong., 1st sess., 1967.

[3]U.S., <u>Statutes at Large</u>, LXXX, Pub. L. 90-62, 90th Cong. (1967).

securities of a foreign business venture is prohibited, except as authorized by the Secretary of Commerce, "from engaging in any transactions involving a direct or indirect transfer of capital to or within any foreign country or to any national thereof outside the United States."[1]

2. Authorized the Secretary of Commerce to require, as he determines necessary, repatriation of earnings attributable to foreign investments and bank deposits and other short-term financial assets held in foreign countries.[2]

3. Authorized the Federal Reserve Board stand-by authority:

> (a) To investigate, regulate or prohibit any transaction by any bank or other financial institution subject to the jurisdiction of the United States involving a direct or indirect transfer of capital to or within any foreign country or to any national thereof outside the United States; and
> (b) To require that any bank or financial institution subject to the jurisdiction of the United States shall cause to be repatriated to the United States such part as the Board may specify of the bank deposits and other short-term financial assets which are held in foreign countries by or for the account of such bank or financial institution.[3]

Restrictions imposed by the Federal Reserve in 1968 on foreign credits by U.S. banks were: (1) to reduce credit ceilings to 103 per cent of foreign credits outstanding as of December 31, 1964; (2) not to renew at maturity outstanding loans to developed countries in Europe; and (3) to reduce

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[1]"Executive Order 11387, Governing Certain Capital Transfers Abroad," Weekly Compilation of Presidential Documents, IV (January 1, 1968), 26.

[2]Ibid. [3]Ibid., p. 27.

short-term loans outstanding to developed countries of continental Europe by 40 per cent of such credits outstanding as of December 31, 1967.[1]

Direct investment limits

The direct investment controls imposed by the President limited new direct investment either through transfer of capital from the United States or through earnings of the foreign venture according to the foreign country concerned. Countries were divided into three categories of less-developed countries, countries that require a high level of capital inflow for the maintenance of economic growth and financial stability, and other developed countries and communist countries.[2] Each category is classified as an A, B, or C schedule with separate limits on direct investments in each schedule. The most restrictive schedule is C, which includes developed countries of continental Europe except for Greece and Finland. No new direct investments could be made in these countries through transfers from the United States, but up to 35 per cent of average earnings of the respective ventures in 1965-66 could be reinvested.[3]

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[1]Council of Economic Advisers, Annual Report of the Council of Economic Advisers (Washington, D.C.: Government Printing Office, 1968), p. 174.

[2]Gottfried Haberler and Thomas Willett, Presidential Measures on Balance of Payments Controls (Washington, D.C.: American Enterprise Institute, 1968), p. 16.

[3]Ibid., p. 17.

Schedule B countries were considered to be those countries that were not yet fully developed and those countries that had in the past relied on a high level of capital inflow from the United States to maintain their economic growth and financial stability; i.e., Canada, Japan, Ireland. New direct investments in Schedule B countries, including reinvested earnings, could not exceed 65 per cent of the 1965-66 direct investment average.[1]

In less developed countries, labeled schedule A, capital transfers from the United States plus reinvested earnings could not exceed in any year 110 per cent of the 1965-66 direct investment average.[2]

Direct investments of $100,000 a year or less were exempt from the foreign direct investment controls. This exemption was later raised to $200,000.

Additional 1968 measures

In addition to these controls, in his statement outlining a program of action on January 1, 1968, the President asked the American people to defer for two years nonessential travel outside the Western Hemisphere and asked for appropriate congressional legislation to achieve this objective of restricting nonessential travel, asked for negotiations with NATO allies to minimize the foreign exchange costs of keeping our troops in Europe, directed the Director of the

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[1] Ibid. [2] Ibid.

Budget to find ways to reduce the number of civilian employees overseas, and instructed the Secretary of Defense to find ways to further reduce the foreign exchange impact of personal spending by U.S. forces and their dependents in Europe.[1]

In an effort to increase exports, the Export-Import Bank Act of 1945 was amended to extend its lending authority and "its authority to issue, against fractional reserves, export credit insurance and guarantees."[2]

Because of the tremendous pressure being exerted on the dollar as foreign nations and citizens converted their "dollar IOU's" into gold, legislation was enacted in March 1968 which eliminated the gold reserve requirements for Federal Reserve notes and for U.S. state notes and treasury notes of 1890.[3] This legislation removed the legal requirements for partial gold backing of dollars circulated within the United States. The remaining U.S. gold supply, approximately ten billion dollars worth, could now be used to meet the international debts of the United States. The total U.S. gold reserve in March 1968 was $10.7 billion, with liquid liabilities to foreigners totaling $32.5 billion.[4] In addition, legislation was enacted in June 1968 which permitted

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[1] Johnson, "Balance of Payments," p. 24.

[2] U.S., Statutes at Large, LXXXI, Pub.L. 90-267, 90th Cong. (1968).

[3] U.S., Statutes at Large, LXXXI, Pub.L. 90-269, 90th Cong. (1968).

[4] Federal Reserve Bulletin, December, 1968, p. A-75, A-86.

U.S. participation in the special drawing rights (SDR's) of the International Monetary Fund which would be used on a limited basis starting in 1970.[1]

Other measures taken in 1968 included additional legislation to enable the Export-Import Bank to approve the extension of certain loan guarantees and insurance on exports in order to improve the balance of payments and foster the long-term commercial interests of the United States.[2] Also, the Foreign Assistance Act of 1968 provided for "a comprehensive review and reorganization of all United States foreign assistance programs, military sales programs, and programs involving contributions and payments by the United States to international lending institutions and other international organizations concerned with the development of friendly foreign countries and areas."[3]

Of interest to the military was the consolidation and revision legislation relating to reimbursable military exports.[4] Under this law the President is allowed to sell military goods for cash or credit to friendly foreign nations.

Before leaving office, President Johnson said that the direct investment control program must be maintained, the

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[1]U.S., Statutes at Large, LXXXI, Pub.L. 90-349, 90th Cong. (1968).

[2]U.S., Statutes at Large, LXXXI, Pub.L. 90-390, 90th Cong. (1968).

[3]U.S., Foreign Assistance Act of 1968, Pub.L. 90-554, 90th Cong., 2d sess., 1968.

[4]U.S., Statutes at Large, LXXXI, Pub.L. 90-269, 90th Cong. (1968).

interest equalization tax must be renewed, and the Federal Reserve program of voluntary restraint of foreign lending continued in order to protect the U.S. balance of payments.[1]

In just a few years, 1964-68, voluntary constraints on investments had proliferated into major mandatory controls.

Proliferation of Major Investment Controls

Federal Reserve Control		Dept. of Commerce Control
	1964	
INTEREST EQUALIZATION TAX Tax equal to 2.75% - 15% of Debt Value		
	1965	
Voluntary Bank Restrictions 105% of 1964 Loan Base		
	1966	
Increase Loans to 109% of 1964 Loan Base		Voluntary Direct Investment Restrictions; 90% of 1962-64 Average Base
	1968	
Mandatory Loan Restriction to 103% of Credits outstanding as of Dec. 31, 1964		Mandatory Direct Investment Controls including Reinvested Earnings. Schedule A: 110% of 1965-66 Avg. Schedule B: 65% of 1965-66 Avg. Schedule C: 35% of 1965-66 Avg Investments of $200,000 or less were Exempt

[1]"The Economic Report for 1969," Speech delivered January 16, 1969, Weekly Compilation of Presidential Documents, V, No. 3 (January 20, 1969), 101.

Mandatory Control Trend Halted, 1969

On April 4, 1969, President Nixon hesitantly took the first steps to relax and reverse government foreign investment regulations as he modified, by Executive Order 11464, the effective tax rate of the Interest Equalization Tax from 1¼ per cent to 3/4 of 1 per cent and partially relaxed the overseas investment restrictions.[1] Repetitiously, he also called for trade expansion, competitive trade policy, more foreign travel to the United States, and a fair share by our friends in sharing the balance of payments common defense costs.

Revisions to investment controls.

Specific revisions made by President Nixon in the regulations governing the overseas investment program were:

> Raising from 200,000 to one million the amount companies could invest and still remain exempt from curbs. [In 1970, an additional four million was exempt if used in underdeveloped countries. In January, 1971, the one million exemption was raised to two million.[2]]
>
> The right for companies to invest 30% of their 1968 foreign earnings as an alternate to using a 1965-66 base period.
>
> Dropping the effective IET rate to 3/4 of one percent. [Congress also extended the IET to March, 1971.[3]]

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[1] Richard Nixon, "Balance of Payments," Statement released April 4, 1969, Weekly Compilation of Presidential Documents, V, No. 14 (April 7, 1969), 509-10.

[2] Annual Report of the Council of Economic Advisers, 1971, p. 145.

[3] U.S., Statutes at Large, Pub.L. 91-128, 91st Cong., 1st sess., 1969. (Passed November 26, 1969.)

Special investment rates for some overseas industries.
A separate export-loan bank ceiling.[1]

The tight money market and high interest rates in the United States caused U.S. banks to borrow over ten billion Euro-dollars in 1969.[2] However, in recognition of normally, historically, higher interest rates outside the United States, the 1970 and 1971 revised guidelines for banks and other financial institutions, with one exception, continued the voluntary restraints in effect since 1965. Banks now will have a general ceiling equal to its old lending ceiling and a separate Export Term-Loan Ceiling equal to one-half of one per cent of its 1968 total assets that can be used to finance new U.S. exports.[3]

Summary

The Interest Equalization Tax imposed in 1964 was apparently effective in restricting foreign access to the U.S. market as the tax raised the purchase cost of foreign securities sold to Americans. However, after its enactment, foreigners switched to long-term borrowing from U.S. banks. Consequently, voluntary bank restriction on loans to 105 per cent of the 1964 loan base was called for in 1965. Since

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[1] "Lifting the Lid a Bit," Business Week, April 12, 1969, p. 36.

[2] Federal Reserve Bulletin, March, 1970, p. A-76.

[3] "Revised Guide Lines for Banks and Nonbank Financial Institutions," Federal Reserve Bulletin, January, 1970, p. 11; and January, 1971, p. 9.

banks are responsive to Federal Reserve directions, they were responsive to the voluntary restrictions.

The voluntary program of restraint on direct investments in 1966 to 90 per cent of the 1962-64 base was partially successful as business feared mandatory controls. However, it appears that in 1967 businesses believed mandatory controls were imminent, and this precipitated a surge of direct investments overseas.

President Johnson considered the controls at least partially successful as he called for their renewal prior to leaving office and there was a $171 million surplus on the liquidity balance in 1968. However, with the same program still in effect, this surplus disappeared into a 1969 record liquidity deficit of $7,012 million. These and other points will be documented and explored in later chapters.

CHAPTER III

INTERNATIONAL PRIVATE INVESTMENT POSITION OF THE UNITED STATES

Historical Review

Direct controls on U.S. overseas private investments, especially direct investments, were the only really significant measures imposed in 1968 by President Johnson to restore the balance in our balance of payments. Yet, these same investments, in the past, had provided the United States, with few exceptions, a surplus in the overall investment account by returning each year more income from prior investments than had been expended each year on new investments.

Historically, Britain, France, and Germany have used income gained from its overseas investments to pay for deficits in other areas of their balance of payments. In the 100-year period 1815-1914, Great Britain accumulated a merchandise trade deficit of nearly $70 billion.[1] More than $50 billion was offset by income from foreign investments.

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[1] Albert Imlah, Economic Elements in the Pax Britannica (Cambridge: Harvard University Press, 1958), pp. 70-75.

Prior to World War II

The United States did not begin to export significant amounts of private capital until almost 1900.[1] Until the end of World War II, the United States, despite its relatively large financial base and size, had relatively little of its financial resources invested in foreign investments. At the end of 1945, total book value of U.S. direct foreign investments was $7.2 billion and other private investments was $6.3 billion.[2]

After World War II

In the immediate years after World War II, 1946-1949, private U.S. capital outflow was insignificant and did not even total one billion dollars a year. A modest increase in private investment occurred during the years 1950-1955. After 1955, probably in anticipation of higher profits and currency convertibility, and as foreign economies displayed increased stability, U.S. overseas private investment increased to over three billion dollars a year and in 1961 finally topped four billion dollars a year. During the period 1961-1969, the United States had an average yearly investment outflow of $4.8 billion a year. Table 1 shows the annual outflow of investment capital for the period 1946-1969.

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[1] Jeffrey G. Williamson, American Growth and the Balance of Payments 1820-1913 (Chapel Hill: University of North Carolina Press, 1964), p. 267.

[2] U.S., Department of Commerce, Balance of Payments Statistical Supplement, (Rev. ed.; Washington, D.C.: Government Printing Office, 1963), p. 248.

TABLE 1

U.S. PRIVATE CAPITAL OUTFLOWS 1946-1969
(Millions of Dollars)

Year	Investments					
	Direct	Portfolio	Other Long-Term	Total Long-Term	Short Term	Total Long- & Short Term
1946	-230	+92	+35	-103	-310	-413
1947	-749	+36	-85	-798	-189	-987
1948	-721	-95	+26	-790	-116	-906
1949	-660	+27	-107	-740	+187	-553
1950	-621	-275	-220	-1116	-149	-1265
1951	-508	-353	-84	-945	-103	-1048
1952	-852	-87	-127	-1066	-94	-1160
1953	-735	+91	+94	-440	+167	-383
1954	-667	-206	-114	-987	-635	-1622
1955	-823	+20	-261	-1064	-191	-1255
1956	-1951	-421	-182	-2554	-517	-3071
1957	-2442	-470	-389	-3301	-276	-3577
1958	-1181	-1250	-194	-2625	-311	-2936
1959	-1372	-668	-258	-2298	-77	-2375
1960	-1674	-662	-193	-2530	-1349	-3878
1961	-1598	-762	-263	-2623	-1556	-4180
1962	-1654	-969	-258	-2881	-546	-3426
1963	-1976	-1105	-593	-3674	-785	-4459
1964	-2328	-677	-1426	-4431	-2147	-6578
1965	-3468	-759	-320	-4547	+753	-3794
1966	-3661	-481	+225	-3917	-415	-4332
1967	-3137	-1266	-26	-4429	-1209	-5638
1968	-3209	-1254	+138	-4325	-1087	-5412
1969	-3070	-1494	-94	-4658	-1133	-5791
	-39,287	-12,988	-4,677	-56,952	-12,087	-69,039

Note: Portfolio investments combine the outflows of capital for foreign bonds and stocks. Other long term is the capital outflow for banks and other claims.

Source: U.S., Department of Commerce, Survey of Current Business, June, 1968, p. 28; October, 1969, p. 26; and October, 1970, p. 24.

The overall value and income derived from U.S. overseas private investments for the post World War II period, 1946-1969, is depicted by Table 2. Total excess of income, fees, and royalty receipts over total private investment outflows for this period was $18.6 billion.

The fact that direct investments comprise almost two-thirds of the total private investments overseas is shown by Table 3. Also worthy of note is the fact that, as depicted by Figure 1, aggregate income inflows from direct investments in the form of repatriated income, royalties and management fees, on a worldwide basis, exceeded direct investment outflows in every year of the period 1946-1969. Direct investment earnings were more than double direct investment outflows. These earnings have substantially contributed to the $31.5 billion increase in the value of direct investments over outflow. In addition, these direct investments have generated repatriated income in the amount of $70.5 billion. For an outflow of $39.3 billion, the United States has gained $102 billion.[1]

Limitations of Definitions

The relationships that exist between these accounts and other accounts in the balance of payments are difficult to perceive. In some cases, because of many intangibles, a

[1]The $102 billion was computed as follows:

1969 total value of direct investments	+70,763
+ Direct investment income repatriated	+70,552
- Direct investment outflow	-39,287
Total gain	$102,028

TABLE 2

U.S. OVERSEAS PRIVATE INVESTMENT POSITION
(Millions of Dollars)

Year	Total Value[a]	Total Capital Outflow	Total Investment Income	Total Investment Fees and Royalties	Total Income
1946	13,525	-413	751	64	815
1947	14,904	-987	1,036	77	1,113
1948	16,301	-906	1,238	83	1,321
1949	16,949	-553	1,297	100	1,397
1950	19,004	-1,265	1,484	126	1,610
1951	20,838	-1,048	1,684	129	1,813
1952	22,731	-1,160	1,624	130	1,754
1953	23,771	-383	1,658	128	1,786
1954	26,594	-1,622	1,955	136	2,091
1955	29,136	-1,255	2,170	158	2,328
1956	33,364	-3,071	2,468	229	2,697
1957	36,930	-3,577	2,612	238	2,850
1958	41,118	-2,936	2,538	246	2,784
1959	44,800	-2,375	2,694	348	3,042
1960	50,266	-3,878	3,000	403	3,403
1961	55,513	-4,180	3,561	463	4,024
1962	58,810	-3,426	3,948	580	4,528
1963	66,513	-4,459	4,151	660	4,811
1964	75,419	-6,578	4,930	756	5,686
1965	81,147	-3,794	5,384	924	6,308
1966	86,321	-4,332	5,659	1,030	6,689
1967	93,603	-5,638	6,235	1,136	7,371
1968	102,519	-5,412	6,922	1,246	8,168
1969	110,152	-5,791	7,906	1,369	9,275
		-69,039	76,905	10,759	87,664

[a]Includes direct investments, portfolio investments, and long- and short-term claims by banks and others.

Source: U.S., Department of Commerce, Balance of Payments of the United States 1949-1951, p. 155; Balance of Payments Statistical Supplement, Rev. ed. 1963, pp. 248-49; Survey of Current Business, September, 1965, p. 23; October, 1968, pp. 20-26; October, 1969, pp. 23-30; and October, 1970, pp. 23-27; The Annual Report of the Council of Economic Advisers, 1971, p. 298.

TABLE 3

U.S. DIRECT INVESTMENTS OVERSEAS
(Millions of Dollars)

Year	Total Value	Earnings	Repatriated Earnings	Fees and Royalties	Direct Investment Income	Direct Investment Outflow
1946	7227	887	588	64	652	-230
1947	8366	1161	869	77	946	-749
1948	9625	1613	1064	83	1147	-721
1949	10700	1408	1112	100	1212	-660
1950	11788	1575	1294	126	1420	-621
1951	12979	2236	1492	129	1621	-508
1952	14721	2327	1419	130	1549	-852
1953	16253	2258	1442	128	1570	-735
1954	17631	2398	1725	136	1861	-667
1955	19395	2878	1912	158	2070	-823
1956	22505	3298	2171	229	2400	-1951
1957	25394	3561	2249	238	2487	-2442
1958	27409	3014	2121	246	2367	-1181
1959	29827	3241	2228	348	2576	-1372
1960	31815	3566	2355	403	2758	-1674
1961	34667	3815	2768	463	3231	-1598
1962	37226	4235	3044	580	3624	-1654
1963	40686	4587	3129	660	3789	-1976
1964	44430	5071	3674	756	4430	-2328
1965	49424	5505	3963	924	4887	-3468
1966	54777	5784	4045	1030	5075	-3661
1967	59486	6116	4517	1136	5653	-3137
1968	64756	7148	4973	1246	6219	-3209
1969	70763	8171	5639	1369	7008	-3070
		85,853	59,793	10,759	70,552	-39,287

Source: U.S., Department of Commerce, Balance of Payments of the United States, 1949-51, p. 152; Balance of Payments Statistical Supplement, Rev. ed., pp. 248-49; Survey of Current Business, September, 1965, p. 23; June, 1968, p. 29; October, 1968, pp. 20-26; October, 1969, pp. 23-30; and October, 1970, pp. 23-27.

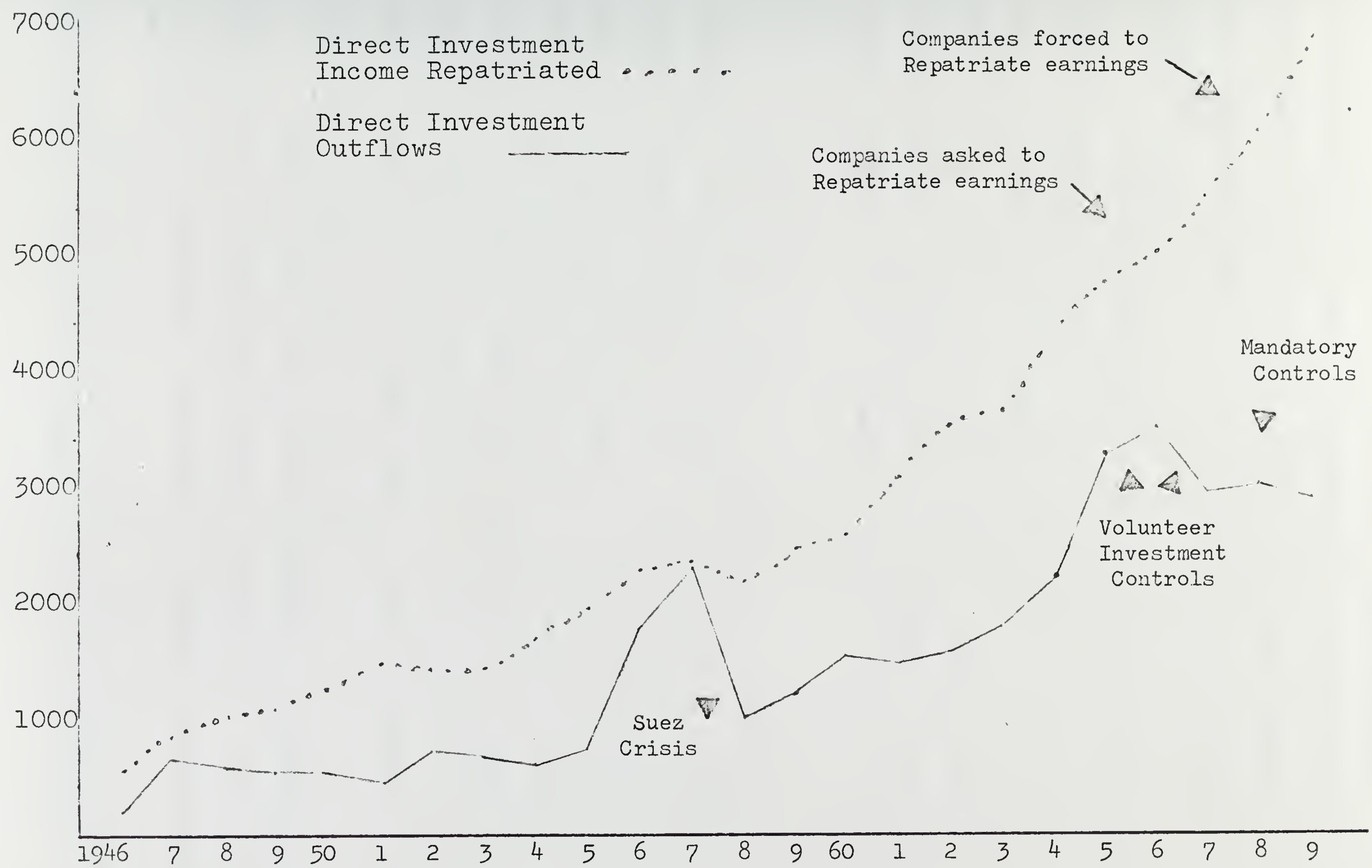

Fig. 1.--U.S. Direct Investment Income Inflows and Direct Investment Outflows (millions of dollars)

Source: (same as Table 3).

shift in one account will vary the other accounts. Also, it is difficult at times to distinguish between a direct investment and a portfolio investment, or in some cases, if an investment was made at all because of the limitations of definitions.

A direct investment refers to an investment made to create something abroad which will make, process, or market goods or something for local consumption and in some cases third areas. Such operations normally employ and weld United States technical expertise, capital and machinery to expand the productive capacities of the country they locate in.

On the other hand, a bank loan or credit to a foreigner is strictly a financial transaction between the lender and the borrower with a fixed maturity, interest rate, and amortization schedule. No equity interest is acquired. A portfolio investment may take two forms--purchase of foreign bonds and debentures or purchase of foreign stocks by a U.S. resident. Bond purchases are like bank credits at fixed terms with no equity interest. Purchases of stocks involve equity interest.

When 25 per cent or more control is attained, the investment is considered a direct investment.[1] This assumes a measure of managerial influence. However, equity ownerships

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[1] U.S., Bureau of the Budget, The Balance of Payments Statistics of the United States, a review and appraisal (Washington, D.C.: Government Printing Office, 1965), p. 62.

of between 10 and 25 per cent have been included as direct investments in the balance of payments data. The President used 10 per cent of control as the point at which direct controls would be applicable.

Tangible Influences of Direct Investments

Sources of funds

Many sources of funds are used to finance direct investments abroad including borrowing from foreign banks, sale of debentures or equities abroad, retained earnings of foreign affiliates, accumulated depreciation and depletion allowances, sales of machinery, services, and technology for credit or equity interest, and sometimes borrowing from U.S. international or foreign government lending or aid agencies. For example, over 80 per cent of the financing of U.S. corporations abroad in 1964 came from external financing abroad and not from direct investments from the United States.[1]

It is also important to understand that capital outflows can be company-affiliate book transactions or credits to finance goods and services.

Royalty income

Income earned in the form of royalty and management fees was recorded in past balance of payments statements as income from miscellaneous services. These royalties and fees

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[1]Samuel Pizer and Frederick Cutler, "Financing and Sales of Foreign Affiliates of U.S. Firms," Survey of Current Business, November, 1965, p. 15.

are more specifically related to direct investments and are now depicted separately on the statement. However, in analyzing the balance of payments statement this income should be attributed to direct investments.

Export influence

Direct investments also have a direct influence on our favorable surplus of exports. A Department of Commerce survey in 1963-1964 revealed that exports to foreign affiliates account for one-fourth of total exports of comparable manufactured goods and semi-manufactured goods from the United States.[1] Foreign affiliates of U.S. companies in the manufacturing and extractive industries imported at least $5 billion of U.S. goods in 1963. All purchases of U.S. goods by the foreign affiliates could not be identified by the parent companies who reported. While not representing total imports by the foreign affiliates, the $5 billion reported constitutes 23 per cent of U.S. exports in 1963.[2]

Exports in 1964 to foreign affiliates increased by nearly 18 per cent.[3] "Exports rose nearly 18% from $5.3

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[1]Samuel Pizer and Frederick Cutler, "U.S. Trade with Foreign Affiliates of U.S. Firms," Survey of Current Business, December, 1964, pp. 20-24. A Department of Commerce source, on February 12, 1971, stated that this study had not been updated.

[2]Ibid.

[3]Samuel Pizer and Frederick Cutler, "U.S. Exports to Foreign Affiliates of U.S. Firms," Survey of Current Business, December, 1965, p. 12. It should be noted that a portion of

billion in 1963 to $6.3 billion in 1964 while total U.S. exports rose about 15%. Exports to the affiliates were 25% of all U.S. exports in 1964 as compared with about 24% in 1962 and 1963."[1] Exports to U.S. foreign affiliates accounted for one-third of total nonagricultural exports.[2]

Department of Commerce findings, therefore, conclusively documented, for the first time, the fact that direct investments have a beneficial impact on exports and that direct investments abroad are essential to the growth of U.S. exports.

Prior to this survey, it had been assumed that exports were dependent mostly on the price and quality of the export and that exports could be promoted by aggressive selling. It is now apparent that corporations can increase their sale of goods in foreign markets, and consequently increase U.S. exports, when they have a presence in that market.

<u>Payback period</u>

Economists and businessmen have argued about the period of time it takes for a direct foreign investment to be offset by income repatriation and other earnings. A

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the increase in exports to affiliates in 1964 might be a result of better bookkeeping by U.S. firms concerned as a consequence of the 1963 survey. (This study on effects of direct investments on exports is the latest available.)

[1] *Ibid.*

[2] *Ibid.*

good example is Professor Bell's study published during the Revenue Act hearings of 1962.[1] To be accurate, in addition to investment income, the payback period should give credit to service and royalty fees, investment which is incurred in the form of equipment, materials and personnel without transfer of dollars, and the additional exports that result from the expansion of operations abroad.

Because of the variables, the exact payback period is undeterminable, but the majority of argument indicates that the capital outflow will have been paid for in a "balance of payments sense" in a period from two to eight years. Table 4 depicts the straight earnings yield on book value of direct foreign investments abroad. Of interest is the fact that for any straight eight to nine year period, the earnings return is nearly 100 per cent of book value.

Unemployment

It has been argued that overseas investments create unemployment and that direct investments also cause an increase in imports. Professor C. P. Kindleberger, Massachusetts Institute of Technology, in a letter to Congressman Thomas B. Curtis, stated:

> It is true that a deficit in the current account in the absence of capital movements is deflationary. When the deficit is in the basic balance, however, or

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[1]Philip W. Bell, "Private Capital Movements and the U.S. Balance-of-Payments Position," Study prepared for U.S. Congress, Joint Economic Committee, Factors Affecting the United States Balance of Payments (Washington, D.C.: Government Printing Office, 1962), p. 405.

TABLE 4

EARNING YIELDS OF DIRECT INVESTMENTS, 1950-1969
(Millions of Dollars)

Year	Direct Investments Book Value	Earnings	Yield (Per Cent) of Book Value
1950	11788	1575	13.4
1951	12979	2236	17.9
1952	14721	2327	15.8
1953	16253	2258	13.9
1954	17631	2398	13.6
1955	19395	2878	14.8
1956	22505	3298	14.7
1957	25394	3561	14.0
1958	27409	3014	11.0
1959	29827	3241	10.9
1960	31815	3566	11.2
1961	34667	3815	11.0
1962	37226	4235	11.4
1963	40686	4587	11.3
1964	44430	5071	11.2
1965	49424	5505	11.1
1966	54711	5784	10.6
1967	59267	6116	10.3
1968	64756	7148	11.0
1969	70763	8171	11.4

Source: Judd Polk _et al._, _U.S. Production Abroad and the Balance of Payments_ (New York: National Industrial Conference Board, 1966), p. 28; U.S. Department of Commerce, _Survey of Current Business_, September, 1965, p. 23; October, 1968, pp. 20-26; October, 1969, p. 29; and October, 1970, p. 26.

in the overall balance the answer--is not given as easily. The outcome depends upon what would have happened to the capital if it had not flowed abroad. If the capital would otherwise have been invested at home and used up local resources, the deficit may be regarded as deflationary, since either domestic investment or full transfer of the capital outflow would have put greater pressure on domestic resources. On the other hand, if the alternative to the capital outflow was merely an increase in liquid savings in the United States, the fact that a part of the capital outflow was transferred through the payments mechanism could be regarded as expansionary. The preferred answer in my judgment, is that a deficit in the basic balance, or in the overall balance, deriving from a current account surplus but a still greater capital outflow, is "relatively deflationary."[1]

Direct investments have many effects on the balance of payments. Each individual investment affects the balance of payments differently depending on the time and method of placement, the payback period, repatriation vice reinvestment of earnings, yields, subsidiary market position, export enhancement, and many other factors.

Adverse effects

Some adverse effects of direct investments on the balance of payments can readily be seen in the U.S. consumer

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[1]Charles P. Kindleberger, in U.S. Congress, Joint Economic Committee, The United States Balance of Payments (Washington, D.C.: Government Printing Office, 1963), p. 425. Mr. Meyer Bernstein, AFL-CIO International Affairs Director, United Steel Workers, in an interview on February 17, 1971, stated that labor takes no formal position on direct investments overseas except when that investment directly interferes with U.S. labor negotiations. He cited the 1967-68 copper strike as an example. Copper companies were able to increase their overall profits by increasing their imports. Consequently, these companies had no incentive to bargain with labor on the settlement of the strike because they were in a better profit position as long as the strike went on.

market. For example, Sears now sells a Japanese-made sewing machine. In answer to a query, a Sears official surmised that Sears gained control of the Japanese company for the sole purpose of having that company produce the sewing machine for the Sears market. Unfortunately, no statistical information is available on how many imports are being received from U.S. companies from their overseas subsidiaries for sales in the United States.[1]

Another adverse effect of direct investments is that some exports would have normally been sold in areas serviced by foreign subsidiaries of U.S. companies. "It is impossible to measure the extent to which foreign sales of affiliates might be substituting for potential U.S. exports or to determine the amount of goods now exported through affiliates that might in any case have been exported through other channels."[2]

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[1]In 1968, Professor Gary Hufbauer (University of New Mexico) and Professor F. Michael Adler (Columbia University) concluded a statistical-economic investigation of the effect of U.S. foreign investments on the displacement of exports by direct investments which was published by the Treasury Department. The study was criticized by the Machinery and Allied Products Institute in a letter dated January 27, 1969, to Henry S. Reuss, Chairman, Subcommittee of International Exchange and Payments, Joint Economic Committee. The letter stated that the "inadequacies of the Treasury study assumptions underlying their economic models invalidate its conclusions." "Explicit recognition by the authors of many or most of these inadequacies does not change the fact." The letter was published in: U.S., Congress, Joint Economic Committee, A Review of Balance of Payments Policies, Hearings, January, 1969, p. 69. On February 12, 1971, a high official in the Department of Commerce, who refused to be quoted, stated that both authors have since recanted their position as set forth in their study and no other studies in this area have been made.

[2]Pizer and Cutler, "U.S. Exports," (Dec. 1965), p. 12.

Indirectly related to direct investments is the influence of foreign aid. Exports financed by foreign aid can be totaled and matched against the appropriation but nobody knows what goods or capital would have been exported if the aid had not been tied to U.S. goods or if a country had not received the aid. More important, substitutions of imports by these countries receiving U.S. aid cannot be identified.[1]

Other Long-Term U.S. Capital

Besides direct investments, considerable foreign portfolio investments were made by U.S. citizens after World War II. The rapid increase in portfolio capital investments from 1958 to 1964 by U.S. citizens can be explained by the high rates of growth in Europe and Japan, the restrictive nature of capital markets in these areas and the much lower interest rates and borrowing costs in the United States. Since 1964, the interest equalization tax has increased the cost to foreigners of raising capital in the United States and accordingly the tax is a restraint on the purchases of foreign securities by U.S. citizens. However, portfolio investments in foreign securities, as shown by Table 1 (page 36), have not significantly decreased since the imposition of the tax. Since the tax is restrictive, it can be assumed that it has had some effect, but the amount of effectiveness

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[1]Peter B. Kenen, Statement in U.S. Congress, Joint Economic Committee, Outlook for United States Balance of Payments, Hearings, 88th Cong., 1st sess., 1963, p. 130.

cannot be measured and the amount of securities that would have been sold without the tax cannot be calculated or estimated.

Other long-term capital movements, both bank and non-bank, are insignificant, except for 1963 and 1964, and are depicted by Table 1. The increase in these two years can be attributed to switching as foreigners borrowed from U.S. banks rather than through the sale of securities which would be subject, after passage, to the provisions of the Interest Equalization Tax Act.

It has been estimated that 15 per cent of long term bank commitments go to developed countries and a somewhat higher portion to less developed countries to directly finance U.S. exports.[1]

Foreign Capital Movement to the United States

Foreign capital movements to the United States during the period 1946-1965 did not have a significant trend. However, since 1965, foreign investments in the United States (Table 5) indicate that foreigners have discovered the U.S. stock market as evidenced by an eight billion dollar shift into corporate bonds and stocks during the period 1965-1969. Also, the drop in corporate stocks held between 1968 and 1969 reflects the drop in the U.S. stock market prices in 1969. Very significant is the fact that U.S. bank loans from

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[1] Federal Reserve Bulletin, March, 1965, p. 365.

TABLE 5

FOREIGN ASSETS AND INVESTMENTS IN THE UNITED STATES
(millions of dollars)

	1965	1968	1969
Non-Liquid	29644	47634	48872
Private	27362	42890	43945
Direct investments	8797	10815	11818
Corporate and Other Bonds	875	4214	4800
Corporate stocks	14599	19551	18140
Liabilities reported by U.S. Banks	513	3166	2490
Other	2578	5144	6697
U.S. Government	2282	4744	4927
Liquid	29115	33614	41918
To Private foreigners	12909	20103	28907
To Banks	7419	14472	23663
To Others	5490	5631	5242
To Foreign Official Agencies	16206	13511	13011
Total U.S. Liabilities to Foreigners	58,759	81,248	90,790

Source: U.S., Department of Commerce, Survey of Current Business, October, 1970, p. 23.

foreign banks increased $16.2 billion during this four-year period. The $9 billion increase in bank loans made between 1968 and 1969 reflects borrowings of U.S. banks in foreign markets. U.S. banks, searching for funds to offset the 1969 tight domestic credit crunch, borrowed heavily in the Euro-dollar market. Regulation Q limits the rates that U.S. banks can pay on domestic deposits but not on deposits obtained through foreign branches which, in effect, stimulated the demand for funds from the foreign financial markets.[1]

It is interesting to note the contrast in the investment pattern of the foreign investor to the U.S. investor. Foreign investors had previously invested the majority of their capital in U.S. portfolio investments and are now switching to corporate stocks and liquid loans. The U.S. investor leans toward direct investments. Perhaps this investment pattern can be attributed to the current U.S. managerial and technical world leadership.

Summary

At the end of 1969, U.S. direct investment overseas had grown to $70.7 billion. Direct investments combined with other U.S. private investments had reached the unprecedented amount of $110.2 billion. In addition, the U.S. Government had nonliquid credits and claims amounting to

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[1]Evelyn M. Parrish, "The U.S. Balance of Payments: Fourth Quarter and Year 1969," Survey of Current Business, March, 1970, p. 27.

$30.7 billion not including $16.9 billion of monetary reserve assets.

Foreign private and governmental investments and assets in the United States amounted to $90.8 billion, of which $41.9 billion was short-term and $48.9 billion ($11.8 billion direct and $37.1 billion portfolio and other) was long-term.

The most significant capital export and import items and their importance can perhaps best be depicted by looking at the major capital transactions for a given period. In 1969, net capital exports were $7.2 billion. The U.S. Government accounted for $2.2 billion and the private sector $5.0 billion. The main outflow of funds in the private sector was for direct investments of $3.0 billion. Foreign securities newly issued in the United States accounted for $1.6 billion, and the remainder can be attributed to U.S. banks.[1] Net capital imports amounted to $12.1 billion, of which $8.4 billion was deposits and money market paper held in the United States. The second major capital import was investments of $3.0 billion in U.S. securities other than Treasury issues.[2] Because of the listing distortions in the major divisions of the accounts, the 1969 private investment income of $9.3 billion is listed under exports of goods and services rather than as an offset to capital exports and imports.

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[1] *Ibid.*, p. 36. [2] *Ibid.*

As ascertained from Tables 1, 2, and 3 (pages 36, 38, and 39), if the income generated from investments is correctly attributed or offset against the capital export account, then capital exports are not causing the persistent deficit in the balance of payments. In fact, the flow of funds into foreign investments has generated a healthy annual repatriation of income which results in a surplus for the private sector. The deficit is not due to capital exports but to government expenditures. This point will be explored further in Chapter V.

Of major importance are the tangible effects direct investments have on other accounts within the balance of payments even though these effects cannot be precisely measured. The majority of the material cited would indicate that restrictions on direct investments have an adverse impact on U.S. exports and other accounts in the U.S. balance of payments.

CHAPTER IV

EVALUATION OF THE EFFECTIVENESS OF CONTROLS

Since 1959, governmental restraints and controls to protect the balance of payments have progressed gradually from mild voluntary programs on private investments to strict mandatory controls. A review of presidential measures and legislation enacted by the Congress to eliminate this persistent deficit reveals that every major presidential proposal also called for:

1. Reduction of overseas military expenditures affecting the balance of payments.
2. Reduction of other governmental agency spending which might adversely affect the balance of payments.
3. Increasing U.S. exports.
4. Increasing tourism to the United States.

While some reduction in military expenditures overseas was actually realized in earlier years, it is considered that the measures to reduce governmental expenditures that were cited on each occasion were more to placate the American taxpayer and businessman than to reduce actual expenditures because it would be necessary to change radically the American political overseas objectives before substantial reductions in overseas military and other governmental expenditures could be realized. As a matter of record, military expenditures overseas in 1968 increased rather than decreased.

The real burden and brunt of the governmental measures to restore the balance has been borne by American businesses and private investors. Perhaps to psychologically prepare the world and American businesses for the investment controls, restraints and restrictions were called for before mandatory controls were imposed.

Legality of mandatory controls

President Johnson used the authority of a Congressional Act of 1917, as amended in 1933, to invoke mandatory controls on direct investments. Essentially, the Act of 1917 authorizes the President to regulate or prohibit any transaction in foreign exchange by any person under United States jurisdiction. The Act forms part of the Trading with the Enemy Act, and the 1933 amendment provides for its use during a national emergency.[1] President Johnson did not declare a national emergency but used the eighteen-year-old national emergency declared by President Truman in Proclamation 2914 of December 16, 1950.[2] The national emergency declared in 1950, and yet to be revoked, was a consequence of the Korean war and had nothing to do with the balance of payments. Since the mandatory controls imposed by the President were not legally contested by U.S. businesses or the Congress, it is

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[1]"Executive Order 11387, Governing Certain Capital Transfers Abroad," Weekly Compilation of Presidential Documents, IV (January 1, 1968), 26.

[2]Ibid.

assumed that the imposition of investment controls under these laws was legal and valid, regardless of the ethics in imposing the controls under laws that were not relevant.

Review of Early Constraints to Improve Balance

Unfortunately, it is impossible to measure the exact effects of each restriction on the U.S. economy or on the world economy. However, one must remember the complex interacting phenomena in the balance of payments, in that the payments are the result of numerous interacting forces, both domestic and foreign, and when one force is changed other forces in the balance of payments also change either tangible or intangible to the original force change.

Government expenditures

Several observations on the tangible effects of these restrictions can be made. The 1959 restriction required AID purchases to be made in the United States in order to reduce the foreign exchange cost of AID. This policy forced recipients of AID to buy goods in the United States regardless of the price. This policy amounts to a partial devaluation of the foreign aid dollar since it usually means paying higher prices, sometimes as high as 30 per cent or more.[1] Since 1962, the Department of Defense has required that goods

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[1] Gottfried Haberler and Thomas Willett, Presidential Measures on Balance of Payments Controls (Washington: American Enterprise Institute, 1968), p. 8.

and services for overseas use be purchased in the United States unless the dollar cost raises the price by 50 per cent or more. This policy can be described as a partial devaluation because it has meant that substantially more dollars are needed to provide the same military effort abroad. In other words, the military must pay up to 50 per cent more on some of its purchases because the purchases must be procured from a United States source.[1] With respect to defense purchases overseas for use in the United States, Executive Order 10582 establishes 6 per cent, plus duty, as the price differential beyond which the price of domestic products will normally be considered unreasonable.[2]

Encourage capital to stay at home

In the early sixties, administrative exports thought that faster economic growth would solve the problem as U.S. exports would increase and U.S. capital would be encouraged to stay at home. The economy expanded but the capital outflow increased rather than decreased. Apparently, administration officials were victims of the fallacy that high profits attract overseas direct investments. Actually, many direct investments overseas earn less than a comparable investment

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[1] Ibid., p. 9.

[2] U.S., Congress, Joint Economic Committee, The United States Balance of Payments--Perspectives and Policies (Washington, D.C.: Government Printing Office, 1963), p. 96.

in the United States. The average earnings of U.S. direct investments overseas in 1967 was 10.3 per cent as compared to an 11.1 per cent profit after taxes in 1967 for corporate investments in the United States.[1] Corporate taxes in foreign countries are roughly the same as U.S. corporate taxes.[2] While profit is the motivation of investment, the majority of overseas investment decisions are made apparently in response to competitive necessities that affect the earning position of the companies involved or threaten their overall operation or market position.[3]

Operation mix

After the failure of the expanding economy to reduce capital outflow and eliminate the balance of payments deficit, the Administration tried manipulating fiscal and monetary policy and juggling interest rates.

> Operation "mix" combined comparatively tight money, that is, high interest rates, with an expansionary fiscal policy [budget deficits]. The former was supposed to improve the balance-of-payments problem by inducing capital to stay at home. The latter, deficit financing, would look after internal expansion.[4]

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[1]See Table 4 for earning yields on foreign direct investments. U.S. corporate profits computed from Table IX, Survey of Current Business, September, 1968, p. 9.

[2]Stanley S. Surrey, Assistant Secretary of the Treasury, A Review of Balance of Payments Policies, Statement to U.S. Congress, Joint Economic Committee, 1969 (Washington, D.C.: Government Printing Office, 1969), p. 37.

[3]Judd Polk et al., U.S. Production Abroad and the Balance of Payments (New York: National Industrial Conference Board, 1966), p. 42.

[4]Haberler and Willett, Presidential Measures, p. 11.

Operation twist

Operation "twist" followed operation "mix." This policy combined high short-term interest rates and comparatively low long-term rates. The high short-term rates would attract capital while low long-term rates would supplement deficit financing and stimulate internal growth and employment.[1] This policy actually stimulated portfolio investment in foreign securities, encouraged direct investments abroad, and consequently had an adverse effect on the balance of payments.

In this study of capital outflows during this period, economist John Hogan commented:

> The chagrin felt by the Kennedy Administration over the dissipation of gains in the basic balance through capital outflows foreordained that U.S. balance of payments policies would be amended to cope with capital flow problems. Short-term interest rates in the United States had been increased in a delicate operation which sought at the same time to constrain long-term rates as a precaution against interruption of the two-year-old economic expansion. Since unemployment of the labor force and underutilization of industrial capacity were still serious problems at the beginning of 1963, some action course other than increased interest rates would have to be determined.
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> . . . .
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> It was immediately clear that a policy-mix including some form of control on capital flows would now be necessary and, given the exigency of the deficit, immediately forthcoming.[2]

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[1]*Ibid.*

[2]John D. Hogan, *The U.S. Balance of Payments and Capital Flows* (New York: Praeger, 1967), p. 115.

Speculative movement of capital

On the effects of interest rates, Edward Bernstein, a research economist, appearing before the Joint Economic Committee, testified that short-term funds follow the interest rate.[1] To illustrate his point, he used Secretary Dillon's testimony of February 14, 1961, before the Foreign Relations Committee. Secretary Dillon had observed that in 1960 the U.S. Federal Reserve discount rate was 4 per cent, the German Bundesbank rate was also 4 per cent, and the Bank of England had a 5 per cent rate. As business began to slow in the United States, the Federal Reserve eased its rate to 3½ per cent. However, in Germany there was a domestic boom and the German Bundesbank raised its rate to 5 per cent. The Bank of England immediately raised its rate to 6 per cent.[2]

As a consequence of the imbalance in short term rates, a flood of short-term funds left New York for these markets. The balance of payments deficit jumped from a $2.9 billion rate in the first six months of 1960 to a $4.7 billion rate in the last six months. This caused an outflow of U.S. gold, as confidence in the dollar was shaken.[3]

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[1] Edward M. Bernstein, in U.S., Congress, Joint Economic Committee, Outlook for United States Balance of Payments, Hearings, 88th Cong., 1st sess., 1963, p. 205.

[2] Ibid.

[3] Ibid.

> The lesson to be learned by all this is that in these days of convertible currencies there must be close cooperation and coordination between our financial and monetary authorities and those of the major industrialized countries of Western Europe.[1]

With regard to private short-term capital movements, experience has shown the difficulty of curbing speculative or other large-scale movements of such funds even with exchange control.[2] While some short-term capital is used to finance exports, some of the capital is speculative and follows the interest rates. In addition, short-term capital is responsive to weak economies and contributes greatly to flights of capital when economic conditions unstabilize.

Interest Equalization Tax

Manipulations of policy and the juggling of the interest rates did not stop the capital outflow and the Interest Equalization Tax was enacted in 1964. Essentially, this tax was a sharp devaluation of the foreign portfolio investment dollar as the foreign investment becomes more expensive in terms of dollars than it would be without the tax. The tax allows the United States to maintain, if desired, low long-term interest rates without risking a substantial outflow of capital to higher interest rates. The tax was effective in stabilizing the amount of capital raised in this country by foreign countries and companies.

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[1] *Ibid.*

[2] Arthur I. Bloomfield, in U.S. Congress, Joint Economic Committee, *The United States Balance of Payments* (1963), p. 352.

Voluntary bank constraints

The so-called "voluntary" program to reduce bank lending abroad administered by the Federal Reserve is a misnomer in that no bank can afford to be on bad terms with the Federal Reserve. Consequently, the voluntary program is really a mandatory restraint on foreign bank lending.

Voluntary direct investment constraints

Because of the voluntary restrictive program that began in 1965, U.S. incorporated companies with affiliates abroad began borrowing money in foreign capital markets and used the proceeds of such borrowings to finance investments in their affiliates.[1] Although interest rates were significantly higher than in the United States, the companies placed a large number of these issues during early 1966 on the Euro-bond market.[2] United States companies were forced

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[1]Emil L. Nelson and Frederick Cutler, "The International Investment Position of the United States in 1967," Survey of Current Business, October, 1968, p. 22.

[2]The Euro-dollar market is a market within a country for bank deposits denominated in foreign currencies. The great preponderance of such deposits is denominated in U.S. dollars. The size of the market in 1969 was estimated to be $30 billion. The Euro-dollar market converts deposits into earning assets through interest arbitrage operations with other foreign banks or through direct conversion into loans or investments. The market is an over-the-telephone market without a pledge of collateral. Trading units are usually in blocks of $1 million or more. The Euro-Dollar Market and Its Public Policy Implications, Paper No. 12, prepared for use of the Joint Economic Committee (Washington, D.C.: Government Printing Office, 1970), pp. 1-8.

to offer higher yields on these bonds as competition for funds in the Euro-bond market increased. Companies switched to bonds convertible into stock of the U.S. parent company in order to hold the yields down.[1] Such borrowings at a higher rate of interest increase the costs of doing business for the U.S. affiliates, and bonds converted into stock could possibly dilute the future earnings of the present investors.

President Johnson's Program

The three essential elements of President Johnson's program to eliminate the deficit were (1) proposed travel expenditure tax, (2) imposition of border taxes, (3) mandatory controls over direct investments.

Travel expenditure tax

The travel expenditure tax would be designed to slow down travel to foreign countries by U.S. citizens. This tax proposal was very unpopular with Congress and the U.S. public, and therefore a tax was not imposed. Any tax which would restrict American travel would be likely to lead to retaliation by other countries and also to widespread evasion of the tax. Consequently, any tax on United States citizens traveling abroad would be self-defeating. Also, any serious consideration of such a tax would spur U.S. citizens into traveling before a tax could be imposed, and therefore not even a short-term surplus or advantage would be realized.

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[1]Nelson and Cutler, "International Investment Position in 1967," p. 31.

Border taxes

The imposition of border taxes would necessitate establishing a new governmental agency to administer and collect the tax. This would result in considerable inefficiency and cost. It would reverse the United States policy of removing trade barriers. It would cause other countries to retaliate, and consequently no real advantage would accrue. Eventually such a tax would become a political tool.

Direct investment controls

The last major element of President Johnson's program was the imposition of controls on direct investments. The reason for these controls was not clear, as businesses had generally adhered to previous voluntary guidelines except in 1967 when the feeling grew among businesses that the Administration was considering further controls. Businesses, in general, had partially adjusted to the previously imposed voluntary controls, and consequently the impact of direct controls was not as severe as it would have been.

Capital shifts

The announcement of mandatory curbs on foreign direct investment transactions intensified borrowings by U.S. companies and pushed up rates in the Euro-bond market to a 7-7.5 per cent yield and led to a pronounced shift to the use of convertible issues during the period of high

yields.[1] The Euro-bond cannot legally be sold to an American except through the secondary market with payment of the interest equalization tax. "As one Swiss banker puts it 'a present to the non-American investor from the U.S. Government and U.S. Corporations.'"[2]

> There is a common assumption that the U.S. balance of payments is unaffected when American companies borrow through the medium of convertible Euro-bonds. But estimates indicate that perhaps as much as one-third of the money going into convertible bonds now was switched out of other dollar securities or diverted from direct investment in Wall Street. Swiss bankers think the switching is growing more and more pronounced to the point where one of them says that convertibles really constitute an undermining of the Johnson measures "to protect the balance of payments." Specially, he adds "the recent Chrysler issues were in large measure bought with money realized from the sales of Chrysler shares."[3]

This shifting of funds vividly illustrates the fungibility of money and the inadequacy of any controls to regulate supply and demand in a free or quasi-free economy.

Repatriation of earnings

The restrictions on private direct investments also contain another far reaching implication which will inhibit the growth and future returns of U.S. company affiliates abroad. Since companies can only reinvest 35 per cent of their earnings in developed countries and 65 per cent of their

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[1]Direct investments by U.S. companies which are financed by funds raised abroad are not subject to the mandatory controls.

[2]*Fortune*, September 15, 1968, p. 3.

[3]Robert Ball, "Personal Investing," *Fortune*, September 15, 1968, p. 159.

earnings in intermediate developed countries, the balance has to be repatriated except where laws of the foreign country prohibit such repatriation. The effects of these controls on U.S. multinational corporations were summarized by a U.S. manufacturer:

> The regulations force us to borrow funds we do not need. They oblige us to bring back to the United States an abnormal amount of dollars. They make it more difficult to finance exports through the medium of foreign affiliated companies. They make planning for the future difficult and uncertain."[1]

Perhaps even more harm is being done to many smaller U.S. corporations undertaking foreign business activities because of the administrative and psychological barriers resulting from the strict regulatory limitations on the retention of profits. These funds could be used by these companies for expansion and payment of debts.[2]

Tax on dividends

Because of the necessity of the affiliate to pay to foreign governments a tax on the dividends sent to the parent, there is an additional reduction of funds available to the company. If the United States did not require repatriation, this tax would not have been otherwise paid until such time that the company felt that economic conditions within the company required such repatriation.

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[1]Institute of U.S. Taxation of Foreign Income, Inc., New York, in U.S. Congress, Joint Economic Committee, A Review of Balance of Payments Policies, Hearings, 1969, (Washington, D.C.: Government Printing Office, 1969), p. 255.

[2]Ibid.

Consequently, it is an additional burden on earnings of the affiliate which degrades its overall market position. "Some companies are having to borrow funds to meet the repatriation requirements."[1]

Cumbersome regulations

The issuance of detailed regulations to carry out President Johnson's program is the responsibility of the Office of Foreign Direct Investments (OFDI). The Commerce Department office has codified these regulations into a fifty-page document[2] which contains legal and technical language that would confuse and discourage any normal businessman. "Not even the OFDI's own staff agree on what the provisions mean."[3]

Analysis of Results of President Johnson's Program

Since the mandatory controls on direct investments and other investment restrictions were designed to achieve a balance in the U.S. balance of payments in 1968, and since there was a slight surplus of $171 million, it would appear that President Johnson's measures to restore the balance were successful. On January 16, 1969, in his annual message to

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[1]Jack M. Behrman, "Assessing the Foreign Investment Controls," Law and Contemporary Problems (Durham, N.C.: Duke University Law School), Winter, 1969, p. 90.

[2]Code of Federal Regulations, Title 15, Commerce and Foreign Trade, Revised as of January 1, 1970, pp. 391-441.

[3]Behrman, "Assessing Foreign Investment Controls," p. 94.

Congress, President Johnson said: "Our international accounts were in balance in 1968--for the first time since 1957. Much of the improvement came from the program I announced in an atmosphere of world financial crisis a year ago."[1]

At a news conference on January 17, 1969, the President was asked: "How, sir, did you make the deficit in the balance of payments disappear in the last two weeks of your administration?"[2] The President replied that it was a combination of long and hard work and that Secretary Fowler had "spent his last few months going around the world trying to bring as many dollars in as he could." Also, that his policies had encouraged U.S. business institutions to do some of their financing abroad, and foreign investments had been attracted to the United States by the U.S. stock market.[3]

While the balance was restored, the 1968 Presidential measures to restore the balance had, in fact, little effect on the restoration of the balance. However, the controls did apparently inhibit the outflow of funds in the investments accounts but to what extent can not be determined. From a comparison of the 1967 and 1968 international accounts, Table 6, some observations on the effects of the Presidential measures can be made:

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[1]"Economic Report for 1969," Weekly Compilation of Presidential Documents, January 20, 1969, p. 100.

[2]"The President's News Conference of January 17, 1969," National Press Club, Washington, D.C., in Weekly Compilation of Presidential Documents, January 20, 1969, p. 123.

[3]Ibid.

TABLE 6

SELECTED U.S. INTERNATIONAL TRANSACTIONS IN THE 1967 AND 1968 U.S. BALANCE OF PAYMENTS ACCOUNTS

	1967	1968
Exports, Merchandise Adjusted, Excl.Military	+30468	+33598
Imports, Merchandise Adjusted, Excl.Military	-26991	-32972
Balance on Nonmilitary Trade	+ 3477	+ 526
Travel to the U.S. by Foreigners	+ 1646	+ 1770
Travel by U.S. Citizens Abroad	- 3195	- 3022
Balance on Private Travel	- 1549	- 1292
Military Expenditures	- 4340	- 4530
Income from Private U.S. Investments Abroad:		
Direct Investments	+ 4517	+ 4973
Other Private Assets	+ 1717	+ 1949
Fees on Royalties from Direct Investments	+ 1136	+ 1246
Royalties and Fees	+ 7370	+ 8168
Private Payments on Foreign Invest. in U.S.	- 1695	- 2231
Transactions in U.S. Private Assets:		
Direct Investments Overseas	- 3137	- 3209
NET Foreign Securities Transactions	- 1266	- 1266
Long-Term Bank & U.S. Resident Claims	- 4	+ 184
Short-Term Bank & U.S. Resident Claims	- 1214	- 1049
Total Transactions in Private Assets	- 5621	- 5340
Transactions in Private Foreign Assets in the U.S.:		
Direct Investments in U.S.	+ 250	+ 319
U.S. Securities other than Treasury Notes	+ 1016	+ 4360
Long-Term Liabilities Reported by U.S. Banks	+ 989	+ 590
Other Liabilities, Long-Term	+ 89	+ 673
Other Liabilities, Short-Term	+ 388	+ 750
Total Private Foreign Asset Transactions in the U.S.	+ 2732	+ 6692

Source: For 1967: Survey of Current Business, March 1969, p. 32; and October, 1970, p. 23.
For 1968: Survey of Current Business, March, 1970, p. 36; and October, 1970, p. 23.

1. Direct investment overseas did not decrease. The program for 1968 was supposed to reduce direct investments by $1 billion, but investments actually increased $172 million. Consequently, there was a $1,172 million difference in what the program was supposed to do and what it actually did.

2. Foreign lending by financial institutions was to reduce the balance of payments deficit by at least $500 million. It appears that a reduction of $500 million was met.[1]

3. The travel deficit goal was a reduction of this deficit by $500 million. Since no controls or taxes were imposed, this reduction goal was not met. The deficit in the travel account decreased from $1.5 billion to $1.3 billion. This was a difference of $300 million from the announced goal.

4. Balance of payments costs of government commitments overseas were to be reduced $500 million. Despite reductions in government and military overseas staffs, curtailment of overseas travel by the military, increase of military sales to friendly nations, and other unannounced measures, military spending overseas actually increased by $190 million. This resulted in a $690 million difference from the announced program.

5. By reducing trade barriers and providing better export financing and insurance, the nonmilitary trade surplus was to be increased $500 million. Instead of increasing, the

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[1] Federal Reserve Bulletin, January, 1969, p. 11.

nonmilitary trade surplus decreased from a surplus of $3.5 billion to a surplus of $526 million. This difference between the actual surplus and the planned surplus was $3.5 billion.

6. Foreign investment and travel in the United States were to be encouraged, but no planned or announced goals were set.

The effects of the program are tabulated in Table 7. It can readily be determined from Table 7 that President Johnson's program failed completely except that it may have prevented some additional private capital from flowing abroad.

TABLE 7

PRESIDENT JOHNSON'S PROGRAM TO REDUCE/ELIMINATE THE BALANCE OF PAYMENTS DEFICIT (Billions of Dollars)

	Planned Improvement	Actual		Difference	
	+	+	-	+	-
Direct Investments	1.0		.1		1.1
Bank Lending	.5	.5			--
Travel	.5	.2			.3
Military Costs	.5		.2		.7
Trade	.5		3.0		3.5
Totals	+3.0		-2.6		-5.6

Flight of capital to the United States in 1968

Inflation in the United States, with a resultant forty-year high in interest rates, the Czechoslovakia invasion by Russia, and the 1968 Franc crisis caused a major flight of capital from Europe to the United States. As a consequence, the U.S. balance of payments was balanced, with a slight surplus, for the first time in eleven years. Additional military developments which contributed to the "flight of capital" to the United States was the growing strength of the Soviet fleet in the Mediterranean and the unstable Middle East crisis.[1] Also, international tension was eased by the start of the Vietnam peace talks and the United States demonstration of fiscal responsibility with its 1968 tax increase. These events, combined with an overheated U.S. economy and resultant forty-year high in U.S. interest rates, precipitated and encouraged the "flight of capital" from Europe and several billion dollars poured into U.S. investments from foreign sources. These investments coupled with a booming inflationary U.S. economy pushed the U.S. stock market higher. As the market climbed, this encouraged further foreign investment.

Trade advantage loss

One serious adverse effect on the U.S. balance of payments was the loss of some trade advantage. In addition

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[1] "U.S. Stocks Attractive to Foreign Investors," *The Magazine of Wall Street*, February 1, 1969, p. 18.

to some export prices increasing because of inflation, imports increased because of the booming economy and the increased willingness of the U.S. consumer to spend. Real growth was around 5 per cent, with an additional 4 to 5 per cent inflation. Consumers had 7.5 per cent more to spend with consumption rising 8.5 per cent.[1] As a result of the increase in consumption and imports, the U.S. trade balance suffered.

1968 surplus explained

As an overall consequence of these events, $6.5 billion of foreign capital flowed into private investments in the United States in 1968 as compared to $2.7 billion in 1967. This capital inflow was combined with an $8.1 billion return from previous U.S. private overseas investments, of which 5 billion was income from direct investments and 1.2 billion was from direct investment fees and royalties. Accordingly, it is concluded that income from private overseas investments, "special" transactions, and the "flight of capital" from Europe caused the first U.S. balance of payments surplus since 1957 when the Suez crisis caused a similar flight of capital.

The 1969 Liquidity Deficit

While the 1969 liquidity deficit was $7.06 billion, there was an estimated $2.71 billion surplus in 1969 on the official transactions basis. This difference reflects two

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[1]Federal Reserve Bank of New York, Perspective 68 (New York, 1969), p. 3.

major items in the measurements. First, it appears that in 1968, President Johnson, despite controls, was able to attain a surplus in the balance of payments only through some "special" financial transactions. Essentially, by the sales of time deposits with an original maturity of one year or more, and through sales of nonmarketable government securities payable prior to maturity only under special conditions, President Johnson was able to switch $2.82 billion of U.S. liabilities from liquid to nonliquid categories in 1968.[1] In 1969, $3.2 billion was switched back to the liquidity basis as past borrowings became due and were not renewed. This increased the 1969 liquidity deficit by $3.2 billion.[2] About $7.2 billion of the difference between the liquidity and official transactions basis in 1969 can be attributed to the high borrowing of Euro-dollars and other dollars held by foreigners by U.S. banks through their foreign branches. "These bank borrowings count as a deficit on the liquidity basis but are treated basically as a favorable inflow on the official settlement basis."[3]

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[1] U.S., Congress, Joint Economic Committee, The 1969 Economic Report of the President, Hearings, 91st Cong., 1st sess., 1969, p. 412.

[2] "Payments Surplus High in 4th Quarter Failed to Avert Record Deficit for 1969," Wall Street Journal, February 17, 1969, pp. 2-3.

[3] Ibid..

Future Effects of Investment Controls

Three major effects of the mandatory controls on foreign investments starting to appear in the balance of payments accounts are worthy of mention even though the data base is not yet substantial enough for a complete analysis. First, since 1968 the deficit attributable to errors and omissions increased from a -$514 million in 1968 to a -$2,963 million in 1969 and is forecast to be a -$2.04 billion in 1970.[1] Consequently, the United States, in two years, had an adverse flow of funds amounting to $4.9 billion which it cannot account for. In contrast, the average errors and omissions for 1956-60 was a plus $173 and for 1961-65 was a minus $910. Devlin and Kruer suggest that this large increase in errors and omissions reflects unrecorded flows of U.S. funds to the Euro-dollar market.[2]

A second major effect appears to be the substantial increase in investment income paid to foreigners, as illustrated from the following data appearing in the annual report of the Council of Economic Advisers:

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[1]David T. Devlin and George R. Kruer, "The International Investment Position of the United States: Developments in 1969," Survey of Current Business, October, 1970, p. 22; and Annual Report of the Council of Economic Advisers, 1971, p. 298.

[2]Ibid.

	1961-65 Average	1966	1967	1968	1969	1970[a]
Balance on investment income	3.5	4.1	4.5	4.8	4.4	4.3
U.S. investments abroad	4.9	6.3	6.9	7.7	8.8	9.6
Foreign investments in U.S.	-1.3	-2.1	-2.4	-2.9	-4.5	-5.3

[a]Average of first three quarters, seasonally adjusted.

Source: The Annual Report of the Council of Economic Advisers, 1971, p. 148.

It appears from these data that overall interest payments to foreigners has risen sharply since the imposition of the controls and reflects the substantially increased borrowings of U.S. companies and banks in the foreign exchange market.

A third major effect is that future returns through repatriated earnings have been reduced because of the limits imposed on the amount of earnings companies can presently reinvest. This amounts to borrowing future returns to pay today's cost.

Summary

While imposition of direct investment controls may have been politically expedient for the President, it was a short-term solution which will adversely affect future returns. It is possible that the President placed controls on investments in order to limit the outflow of dollars in

the short run and thereby rectify the immediate imbalance while hoping that long-range influences would favorably adjust our international position to a surplus. Since the controls are short-range and partially dependent on periodical congressional action for renewal, it appears that the President completely ignored a long-range program because it was politically expedient or because he considered that long-range influences would actually restore the balance.

Concerning the controls, the statement by the 1968 Joint Economic Committee quoted earlier is an excellent overall summation:

> The Johnson Administration's response to the dollar crisis is a program of short sighted and self-defeating controls. The Administration has swallowed the utterly mistaken notion that the dollar can be strengthened by limiting its usefulness.[1]

Most of these policies were designed to give the United States time to correct the fundamental imbalances in the balance of payments. However, the discriminatory nature of each of these controls has and will continue to generate ill-feeling abroad. For example, in a statement to the 1969 Joint Economic Committee, the Irish Industrial Development Authority pointed out that in order to attract investments in manufacturing, Ireland had given outright cash grants in the amounts of one-third to two-thirds of the cost of land and buildings and had foregone taxes for ten years on

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[1]U.S., Congress, Joint Economic Committee, Joint Economic Report 1968, 90th Cong., 2d sess., 1968, p. 71.

all profits derived from exports of these companies. Repatriation requirements means the return of funds to the United States which "are not attributable to U.S. investment in the first place and taxing in the U.S. of those funds on which the Irish Government has foregone taxes."[1]

How critical is the continuous U.S. deficit? For many countries which have based the international price of their monetary unit on the U.S. dollar, the problem is very critical. For the average U.S. citizen, the problem is remote but also critical as continuous deficit could precipitate a monetary crisis throughout the world with a corresponding drastic reduction in exports and imports with a resultant world economic recession.

The possibility of crisis and world recession almost became a reality in March 1968, when a crisis of confidence in the U.S. dollar occurred and U.S. monetary reserves flowed out of the United States at a rate of more than $400 million a month. By the end of March 1968, the United States had lost $2.4 billion in gold in six months. Rumors of possible devaluation of the dollar climaxed on the weekend of March 16-17, when U.S. tourists in Europe could not change their dollars into foreign currencies or cash their travelers checks. For the European central bankers, a U.S. domestic

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[1]Adrienne Curtin on Behalf of the Irish Industrial Development Authority, in U.S. Congress, Joint Economic Committee, A Review of Balance of Payments Policy, Hearings, 1969, p. 251.

tax increase became a critical test of United States fiscal responsibility.[1]

Partial confidence in the dollar was restored in 1968 with the imposition of a 10 per cent surtax on domestic income and the removal of the partial gold backing of dollars circulated within the United States. These factors, combined with a 1969 all-time high interest rate and the advent of Special Drawing Rights in 1970, took the pressure off the dollar. This is reflected by the fact that United States gold reserves increased by one billion dollars in 1969.[2] However, as long as our deficit continues, it will affect and influence military spending and troop movements abroad, foreign aid, economic growth and stability, business investments, and other military and political decisions relating to international affairs.

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[1]Robert J. Elson, "How the Old Politics Swamped the New Economics," Fortune, September 1, 1968, p. 75.

[2]Federal Reserve Bulletin, March, 1970, p. A75.

CHAPTER V

AN ALTERNATIVE TO CAPITAL EXPORT CONTROLS

In the ten-year period 1959-1968, an increasing number of controls on capital exports were imposed with little effect.

> The policy to restrain capital exports has been a series of failures because it has not been based on sound economic theory. Each failure has been followed by a further escalation and the policy has now reached the stage of comprehensive and drastic mandatory restrictions.[1]

Consequently, the specific controls "must be judged a failure" because the balance in the international accounts, which was promised each for the next has not been achieved.[2] Measures which were only temporary at the beginning were extended and gradually grew into a mandatory program. Two principles have been demonstrated: the "fungibility of money," which enables it to flow abroad despite the artificial restrictions, and how specific and temporary controls tend to multiply and become permanent.[3]

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[1] Gottfried Haberler and Thomas Willett, Presidential Measures on Balance of Payments Controls (Washington, D.C.: American Enterprise Institute, 1968), p. 9.

[2] Ibid., p. 8.

[3] Ibid.

TABLE 8

U.S. BALANCE OF PAYMENTS DEFICITS--
LIQUIDITY BASIS
(Millions of Dollars)

1958	-3365
1959	-3870
1960	-3901
1961	-2370
1962	-2203
1963	-2671
1964	-2800
1965	-1335
1966	-1357
1967	-3544
1968	+ 171
1969	-7012
*1970[a]	-4415
TOTAL	38,670

[a]Estimated

Source: Annual Report of the Council of Economic Advisers, 1971, p. 299.

Alternatives

Reduction of overseas government expenditures

Despite restrictions, American businesses have provided the government each year with a surplus in the private balance of payments accounts. However, the U.S. government consistently spends more than the surplus provided by private business, and a deficit results. In the twenty-two-year period 1946-1967, the private sector in the balance of payments produced a surplus of over $113 billion while the

government sector produced an approximate deficit of $161 billion as follows:[1]

U.S. Government Outflows 1946-1967
(Millions of Dollars)

Net government grants, transfers service payments, and income receipts		$ - 53,668
Net government loans and transactions outstanding		- 24,965
Total economic		$ - 78,633
Military expenditures	-53,980	
LESS: Military sales	+ 7,408	
Net military expenditures	-46,572	
Military grants	-35,943	
Total military		- 82,515
Total economic and military		$ -161,148

These totals show that prior to mandatory controls, the private sector consistently provided large dollar inflows to almost offset the large deficits in the governmental accounts. It would appear that the obvious solution would be to cut government spending or to increase the surplus in the private sector. Yet, it was the private sector that had controls and restraints placed on it. Such controls would eventually inhibit the growth of future income from the private sector.

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[1]Computations from Survey of Current Business, June, 1968, and Annual Report of the Council of Economic Advisers, 1968, pp. 306-07. Surplus from private sector includes net capital flow, investment income, and net exports of goods and services minus imports of goods and services.

The 1968 Joint Economic Committee expressed deep concern over governmental expenditures overseas:

> In the long run, we must recognize that our governmental foreign expenditures (military costs of some $4.25 billion per year), plus some hundreds of millions due to foreign aid leakage are the root of our balance-of-payments difficulties. Our trade accounts, our investment accounts and our travel accounts are all, in combination, in overall balance or slight surplus. Long-term action, therefore, must be concentrated on the governmental account.[1]

The committee went on to explain that it was unreasonable for the United States to expect, in a competitive world, to be able to increase its trade surpluses in order to cover the costs of enormous overseas military expenditures.[2] Also, in the long run, matters could not be improved by reducing imports or by cutting off our flow of investment funds abroad, or by reducing travel of American citizens abroad. "All of these are techniques that will quickly lead to retaliation by other countries."[3]

The Committee concluded that:

> The President's balance-of-payments program is inadequate for it does little about reducing the balance-of-payments cost of our military expenditures abroad. The drain of such expenditures on our reserve position must be terminated quickly.[4]

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[1]U.S., Congress, Joint Economic Committee, *Joint Economic Report 1968* (Washington, D.C.: Government Printing Office, 1968), p. 21.

[2]*Ibid.*

[3]*Ibid.*

[4]*Ibid.*, p. 20.

Reduction of military expenditures

Military expenditures abroad in Europe and Vietnam are the most adverse items in contributing to the U.S. deficit. The annual foreign exchange costs of our troops in Germany were estimated to be about $800 million, and for Vietnam about $1.5 billion per year.[1] Two Yale doctoral candidates in economics, testifying before the 1969 Joint Economic Committee, estimated the direct and indirect balance of payments costs of Vietnam to be in the neighborhood of about $4 billion a year.[2] Additionally, the 1968 Joint Economic Committee estimated that another $2 billion was the foreign exchange cost of the U.S. military posture elsewhere.[3] Representative Moorhead expressed the view that if our military posture had been substantially increased in Vietnam then it would have jeopardized and precipitated a possible collapse of the international monetary system.[4]

Devaluate the dollar

An obvious but extreme alternative for restoring the balance would be to devaluate the dollar. However, competitive devaluations around the world would precipitate

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[1] Ibid.

[2] U.S., Congress, Joint Economic Committee, A Review of Balance of Payments Policies, Hearings, 91st Cong., 1st sess., 1969, p. 109.

[3] U.S., Congress, Joint Economic Committee, Joint Economic Report 1968, p. 20.

[4] Ibid., p. 52.

a world economic crisis and depression. Another method of devaluation would be to raise the price of gold but, eventually, world prices would readjust and a new international reserve crisis would result.[1] Also, raising the price of gold rewards the Soviet Union, South Africa, and some other countries including private speculators. Meanwhile, every nation that had relied on the United States and held dollars in their reserve accounts instead of gold would be penalized.

Increase direct investments overseas

President Johnson rejected a complete reduction of government spending overseas and/or the devaluation of the dollar as alternatives in favor of selected controls. Yet, if these solutions are ruled out for policy reasons, then only one alternative and real solution to our chronic balance of payments problem appears feasible: increase the return of private income from overseas. Since a highly favorable trade surplus appears impossible to sustain in an inflationary economy or in variance to domestic economic policy, then the United States must increase its international income from private overseas investments, and such income is not increased by restricting the base upon which that income must depend and grow.

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[1] *Ibid.*, p. 22.

American industry with its mastery of mass marketing techniques, distribution, and servicing can easily compete in foreign markets with direct investment enterprises while foreign direct investors in the United States could have a serious problem from U.S. competitors. Accordingly, the United States has an economic advantage in technology, research and development, and marketing, which it should capitalize on rather than restrict. Such technology and mass production should be exported through direct investments overseas, as such investments, from a balance of payments sense, return the full balance of payments costs in the form of income and additional exports in two to eight years.

Table 9 illustrates what can be accomplished with direct investment returns. Estimates of balance of payments effects in European manufacturing are shown in two variants.

The earnings rate used in the table is higher than the average 1967-1969 foreign investment return. The table does not consider capital appreciation by inflation or the variances of exports and imports under certain changing economic conditions. Also, the table does not consider that the direct investment is normally far less than the total investment. For example, other capital can be borrowed at a fixed interest cost by the sale of bonds in the foreign market or by borrowing from a foreign bank. Assume that an estimated return of 12 per cent on total

TABLE 9

TWO VARIANTS OF EFFECTS OF DIRECT INVESTMENTS

Variant One: Estimated Balance of Payments Effects of a $1,000 Direct Investment in European Manufacturing[a]

Item	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
(1) New direct investment . .	$1,000	0	0	0	0	0	0	0	0	0	0
(2) Cumulative direct investment end of year	$1,000	$1,081	$1,169	$1,264	$1,366	$1,477	$1,596	$1,725	$1,865	$2,016	$2,179
(3) Export stimulus	0	106	115	124	134	145	157	169	183	198	214
(4) Royalties and fees	0	23	25	27	29	31	34	37	40	43	46
(5) Repatriation earnings . . .	0	87	94	102	110	119	128	139	150	162	175
(6) Import stimulus	0	-65	-70	-76	-82	-89	-96	-104	-112	-121	-131
Balance of payments:[b]											
(7) Annual net effect	-1,000	151	164	177	191	206	223	241	261	282	304
(8) Cumulative effect	-1,000	-849	-685	-508	-317	-111	112	353	614	896	1,200

Table 9--continued

Variant Two: Estimated Balance of Payments Effects of a $1,000 Direct Investment Flow into European Manufacturing[a]

Item	Year 0	Year 1	Year 2	Year 5	Year 6	Year 10	Year 11	Year 12	Year 15
(1) New direct investment . .	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000
(2) Cumulative direct investment end of year	$1,000	$2,081	$3,250	$7,355	$8,951	$16,736	$19,092	$21,638	$30,584
(3) Export stimulus	0	106	221	623	780	$1,543	$1,774	$2,024	$2,901
(4) Royalties and fees . . .	0	23	48	135	169	335	385	439	629
(5) Repatriation earnings . .	0	87	181	511	640	$1,266	$1,456	$1,661	$2,381
(6) Import stimulus	0	-65	-135	-382	-478	-946	-1,088	-1,241	-1,779
Balance of payments:[b]									
(7) Annual effect	-1,000	-849	-635	-113	111	1,198	1,527	1,833	3,132
(8) Cumulative effect	-1,000	-1,849	-2,534	-3,473	-3,362	-306	1,221	3,104	11,188

[a]It is assumed that the investment was made at the end of year 0.

[b]Excluding (1) related export stimulation; (2) American import replacement of foreign-owned production by American-owned production; and (3) displacement of U.S. exports by American-owned foreign production.

Note:
Line 2 = Line 2 for preceding year plus 8.0 percent (retained earnings of current year).
Line 3 = 10.6 percent of investment (Line 2 of preceding year).
Line 4 = 2.3 percent of investment (Line 2 of preceding year).
Line 5 = 51.8 percent of total earnings, which are assumed to be 16.8 percent of investment making retained earnings 8.7 percent of investment (Line 2 of preceding year).
Line 6 = 6.5 percent of investment (Line 2 of preceding year).
Line 7 = Lines 1+3+4+5+6.

SOURCE: Outlook for United States Balance of Payments 1968; Walter Salant et al. (Washington, D.C.: Brookings Institution, 1963).

capital investment induced a company to invest. The company invested $4,000, of which 25 per cent was a direct investment from the United States and 75 per cent was through borrowing or selling bonds in the foreign market at a cost of 8 per cent. A 12 per cent return on $4,000 is $480. An 8 per cent interest cost of $240 is deducted, leaving earnings of $240. Accordingly, the direct investment of $1,000 returned 24 per cent vice 12 per cent. This effect would repatriate the direct investment far faster than that repatriation illustrated by Table 9.

As illustrated by Variant One and Variant Two in Table 9, a logical alternative and long-range solution to the restoration of a balance or surplus is to increase direct investments overseas. This would require the elimination of direct investment controls. However, in eliminating the controls, the short-range stability of the world dollar must be considered.

Removal of Controls

The first direct investment controls which should be immediately eliminated are those controls which limit investments to underdeveloped countries under Schedule A. It is impossible to understand why such controls were ever imposed on these countries, or the ambivalence of U.S. policies toward these countries. For example, the Foreign Assistance Act of 1969 created the Overseas Investment Corporation to mobilize and facilitate the use of U.S.

private capital and skills in the economic and social progress of less developed countries. This corporation encourages direct investments in underdeveloped countries by guaranteeing such investments against loss due to confiscation, expropriating, war, revolution, or insurrection. It was incorporated at $20 million as an "agency of the United States under the policy guidance of the Secretary of State."[1] The Corporation has a maximum insurance contingent liability for private investments at any one time of $7.5 billion.[2] By insurance, the Department of State encourages direct investments in underdeveloped nations while the Department of Commerce restricts such investments. This ambivalence is a striking sign of bureaucratic incompetence.

Early in 1969, prior to the creation of the Overseas Investment Corporation, Charles Fiero, Director of Foreign Direct Investments, U.S. Department of Commerce, testified before the Joint Economic Committee that the direct investment quotas for underdeveloped countries had not been fully utilized. The Committee appeared to have him in a difficult situation on this point when they asked him why he had quotas for these countries if they are not utilized. Mr. Fiero was unresponsive to this point, as he testified that if quotas were removed for these countries it would probably

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[1] U.S., Statutes at Large, Public Law 91-175, 91st Cong., 1st sess., 1969.

[2] Ibid.

result in one-half-billion-dollar balance of payments costs. His reasoning is unclear and unexplained, as he first testified that controls were not restricting investments in these countries; yet, removal of the quotas would result in a half-billion-dollar movement of direct investment funds to these countries over the then established quotas, which had not been fully utilized.[1]

The second step in the removal of the controls would be to eliminate the requirement to repatriate in effect 35 per cent of earnings from schedule B countries. This would permit companies to reinvest in profitable expansion through the use of retained earnings. Since there is a tax by the foreign government on earnings repatriated, the cost of expansion through earnings would be cheaper for these companies. Following this, all direct investment quotas should be removed.

The last but greatest impact on our balance of payments would be the removal of direct investment controls in schedule C countries, basically Western Europe. Repatriation of earnings in these countries is forcing U.S. subsidiaries to borrow money in order to repatriate earnings. Elimination of the controls would enhance their competitive position and growth, which would greatly contribute to their future income and the repatriation of income to the United States.

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[1]U.S., Congress, Joint Economic Committee, Review of the Balance of Payments Policies, pp. 141, 192-93.

If the United States desires a maximum amount of earnings repatriated in any given period of time, it should give these companies a tax incentive, not a mandatory directive. An extreme tax incentive would be not to tax any of the returns provided no direct investments were made to the company from the United States. This would encourage companies to expand through borrowings in the Euro-dollar market, which in turn would help keep the dollar stable. At the same time, the higher costs to these companies in dealing in the Euro-dollar market would be offset by the tax advantage gained on repatriated earnings.

In the short run, if a temporary deficit could not be sustained, the immediate imbalance caused by increasing overseas investments would have to be offset. International dollar stability could be maintained by U.S. banks for a given period of time. U.S. banks could be encouraged and directed to borrow and hold Euro-dollars for stabilization purposes. The interest cost on such bank borrowings would be less than the returns on the U.S. expanding direct investments. The U.S. Federal Reserve could reimburse U.S. banks for their costs. Eventually, direct investments would resolve the balance and obviate the need for bank borrowings. In addition, the U.S. Federal Reserve could intervene in European money markets,by buying or selling forward exchange, to stabilize the dollar. A recent example of such stabilization was the intervention of the Federal Reserve in the trading of the German mark. In order to

stem the flow of Euro-dollars to Germany, which was undermining the German anti-inflationary measures, the New York Federal Reserve Bank sold Deutsche marks three months forward. By so doing, the Federal Reserve increased the cost of swapping Euro-dollars to higher-yielding marks.[1]

Summary

Expanding direct investments would not only repatriate themselves in a balance of payments sense in a few years but would also provide for a growing surplus in the investment account, which would eventually provide a surplus, other factors remaining relatively constant, in the overall balance of payments. By immediately terminating some of the direct investment controls, followed by a reversal of others, overseas direct investments would increase. International dollar stability could be maintained by U.S. banks and the Federal Reserve until such time as repatriation of earnings from direct investments balance the accounts.

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[1]"N.Y. Fed. Acts on Flow of Eurodollars," The Sunday Star (Washington), February 28, 1971, p. D11:8.

CHAPTER VI

RECOMMENDATIONS AND CONCLUSIONS

The strong viewpoint expressed by the 1968 Joint Economic Committee against maintaining our overseas military posture in order to reduce our balance of payments exchange costs is considered extreme.

However, this view points out how serious, sensitive, ridiculous and detrimental to sound military and political judgment the imbalance in our international accounts has become. Basing a strictly military decision on the foreign exchange cost of that military decision is considered an extreme folly. Whether or not military commitments overseas should be maintained, increased, or decreased should be based on sound political policies and judgments made in the light of international treaties, commitments, goodwill, and harmony and not on the foreign exchange costs of such policies.

The basic problem is not and has not been world liquidity. The basic problem is the persistent United States balance of payments deficit. If the United States balance of payments deficits continue substantially in the future, these deficits will jeopardize the new Special Drawing Rights which in its infancy is dependent upon the international

stability of the dollar. Consequently, it is imperative that international confidence in the dollar be maintained now and in the future.

Controls Are Self-Defeating

Contrary to the Johnson Administration's reasons for imposing controls on investments, it is concluded that the controls are self-defeating, whether voluntary or mandatory, and that they jeopardize the present as well as the future U.S. balance of payments position and growth of the world economy:

1. Why should anyone hold dollars when more extreme controls seem likely if present controls do not accomplish their purpose?

2. Since an estimated one-quarter of U.S. exports are purchased by U.S. overseas affiliates, restrictions on their expansion will also limit the future expansion of exports.

3. Some forms of direct investments were transfers of capital inventory and equipment and resulted in an increase in exports without any investment capital leaving the country. These transfers count against the company as a direct investment. Consequently, because of the direct investment restrictions, overseas affiliates can possibly defer such purchases or buy comparative equipment in a foreign country. Therefore, as companies strive to maintain their investments within the control limitations established, exports of this nature from the United States can be expected to decline. Accordingly,

a reduction of this type of investment should be expected with a resultant decrease in exports.

4. Investment controls increase the costs and restrict new capital investments in U.S. overseas subsidiaries by U.S. citizens. Consequently, foreign businesses gain an advantage over the U.S. subsidiary competitor.

5. There are inequitable features which will eventually result in political difficulties with friendly nations.

6. In the long run, a reduction of economic growth will result in those countries where investments would have been made. This is not in the best interests of the United States and is actually contrary to foreign aid objectives.

7. Controls discriminate against any new investments or newer companies in favor of the established U.S. subsidiary which can usually obtain some capital in foreign local markets.

8. Controls could foster the development of hostile trade blocs especially if a border tax is also imposed.

9. These controls could foster the retaliation and/or restrictions by foreign governments on foreign investments by their citizens.

10. The repatriation of earnings by U.S. subsidiaries is not subject to direction by the Secretary of Commerce or the Treasury although unfair discriminatory and political action and pressure might be applied by the Department of Commerce. U.S. subsidiaries are subject to the laws of the countries in which they locate and repatriation of

earnings over a certain amount might be in direct violation or opposition to the policies of that foreign country. Brazil is a good example. Consequently, Executive Order 11387, which authorizes the Secretary of Commerce to require such repatriation, appears to be an untenable requirement.

11. Earnings that are repatriated because of governmental pressure or controls, which would not have been repatriated in the current year, provide an expedient method for the government to borrow future foreign exchange returns in order to partially satisfy the current deficit. Of course, such repatriation will aggravate future balance of payments positions.

12. Since investments are restricted, future income is also reduced. In addition, since some companies may lose their competitiveness because of the high cost of foreign capital, loss of income from previous investments might also result. Table 4 (page 46) shows that the straight earnings yield of direct foreign investments has dropped from a 1960-1965 average of 11.2 per cent to a 1967 low of 10.3 per cent. Perhaps this earnings loss is a direct reflection of investment controls and the increased cost of foreign capital and/or the partial loss of competitiveness due to lack of adequate capital.

13. A deceiving but serious consequence of these investment controls is the degradation of preemptive technology, maintenance and management. It can be readily understood

that once certain types of technology, equipment, maintenance, and management have been successfully established in a foreign country, it would probably prevent or preempt the establishment of a similar investment by other countries. Assuming that rapport and goodwill were established by the U.S. management, the foreign country would probably be receptive to other types of U.S. investments. Some countries allow the establishment of only one foreign industry in an area, or the country may even permit a monopoly in order to induce and insure an adequate return on a large investment. Also, a company which has established itself and a market has a definite competitive advantage over a newcomer. Accordingly, controls will eventually degrade our overall position.

Recommendations to Restore the Balance

Since common sense dictates that we cure our balance of payments deficit through economic adjustments rather than by artificial stimulation and restrictions, the following recommendations are made to bring about a balance and inevitably a surplus in the U.S. balance of payments:

1. Increase U.S. direct investments overseas subject to normal economic constraints.

2. Increase foreign portfolio investments in the United States in order to offset the immediate balance of payments costs of the direct investments.

3. Increase U.S. Government borrowing from foreign governments in order to offset the immediate cost of direct investments.

4. Decrease U.S. long-term bank loans overseas except those loans financing U.S. exports. In contrast, U.S. banks should borrow Euro-dollars commensurate with international dollar stability until repatriation of earnings from direct investments offset the deficit. After a surplus is achieved through direct investment returns, allow economic conditions to determine long-term bank loans.

5. After a surplus has been achieved and long-term bank loans stabilized, remove the interest equalization tax to allow economic conditions to determine the movement of portfolio investments.

Repatriated earnings

Even if these recommendations were not followed, the United States by not tampering with the economic flow of repatriated earnings, everything else remaining constant, could eventually return to an overall surplus in its balance of payments accounts through the surplus generated by its private investment account. With over $70 billion of overseas direct investments which earn over $7 billion, new direct investments from earnings in the first year would be over $3.5 billion assuming a 50 per cent reinvestment rate.

Other measures

Other measures which would improve the balance include:

1. Maintenance of U.S. domestic cost and price stability. Note that if the United States does not maintain a reasonable domestic cost and price stability, any measure to restore the balance would be superfluous as inflation would deteriorate our trade balance to an extent that no measures short of devaluation of the dollar could restore the balance.

2. Maintenance of high interest rates without artificial supports.

3. A deflation or recession in the United States which would lower export prices, reduce imports, and attract overseas investments by the attractiveness of good investments at reduced prices. This is an economic solution and bad domestic politics.

4. Maintenance of domestic financial fiscal responsibility. This would reduce governmental induced inflationary pressures. Such fiscal responsibility would also further enhance international confidence in the U.S. dollar.

5. Establishment of a positive effective tourist program which would entice foreign visitors to the United States.

6. Elimination of non-tariff barrier restrictions by foreign countries such as Great Britain's requirement that

a sum equal to 50 per cent of the import value will be deposited with British customs for six months.

7. Reduction of import quotas and restrictions that are in reality unfair trade practices. Japan import restrictions include 121 items that U.S. officials state are in violation of GATT (General Agreement on Tariffs and Trade) provisions.[1] "Henry Ford II, chairman of Ford Motor Co., called the Japanese attitude toward import restrictions 'kind of stupid.'"[2] However, some Japanese argue that they must liberalize because of the growing protectionist attitude in the United States.[3]

8. Elimination of strikes which adversely affect our balance of payments such as the 1968 East Coast dock strike and copper strike.[4] The copper mining strike was estimated to have cost the United States $80 million a month in balance of payments losses.[5]

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[1]Philip Shabecoff, "U.S. Ties with Japan Face Growing Strain as Economic Frictions Multiply," The New York Times, October 8, 1968, p. 77, col. 1.

[2]"U.S. Wins Only Few of Concessions Sought in Japan Trade Talks," Wall Street Journal, December 30, 1968, p. 10, col. 1.

[3]Ibid.

[4]U.S., Congress, Joint Economic Committee, A Review of Balance of Payments Policies (Washington, D.C.: Government Printing Office, 1969), p. 5.

[5]U.S., Congress, Joint Economic Committee, Joint Economic Report 1968 (Washington, D.C.: Government Printing Office, 1968), p. 76.

9. Reduction of prices by industries on certain exports in order to compete in foreign markets and at the same time maintain plant capacity. Of course, "dumping" cannot be allowed. For example, U.S. cold-rolled sheet steel is being sold in Japan for about $118 a ton while the price in the United States is $144 a ton.[1] At least the steel plants are recovering some fixed costs on what otherwise would be idle capacity. Also, 100 per cent of AID financed steel for foreign countries must be made in the United States, and this amounts to 40 per cent of total steel exports.[2]

10. Replacing government assistance programs such as AID with private enterprise groups. These private groups should have the dominant major role in economic development of less developed countries. The Atlantic Community Development Group for Latin America (ADELA) cited in the 1965 Joint Economic Report is a good example.[3] Another company formed in February 1969 is the Private Investment Company in Asia (PICA). This company is capitalized at $40 million with one-third of the investment being from the United States and two-thirds being from other foreign countries.[4]

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[1]"Steel Mills Sharply Boost Export Sales; Prices Slashed in Bid to Open New Markets," Wall Street Journal, December 27, 1968, p. 5, col. 3.

[2]Ibid.

[3]U.S., Congress, Joint Economic Committee, Joint Economic Report 1965, p. 77.

[4]John Hallon, "Private Investment Company for Asia," Congressional Record, January 17, 1969, p. S545.

Conclusion

While President Nixon's approach to reversal of investment controls appears to be cautious, the creation of the Overseas Investment Corporation on December 30, 1969, to mobilize and facilitate the use of U.S. private capital and skills in the economic and social progress of less developed countries should have a profound positive effect on our future balance of payments.[1] The corporation, with a very modest appropriation of $20 million to start, will guarantee private investment in underdeveloped countries against loss due to confiscation, expropriation, war, revolution, or insurrection. While there appears to be considerable ambivalence between direct government controls restricting investments and the Foreign Assistance Act encouraging investments, it appears that this ambivalence could be slowly resolved if President Nixon were to stabilize the economy and move toward the further liberalization of overseas investment controls.

It is concluded that, with the income and growth that could be provided especially through direct investments, the United States in years to come could enjoy a healthy surplus in its balance of payments. This surplus would allow the United States to pursue its international political and military objectives with its international financial

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[1]U.S., Statutes at Large, Pub.L. 91-175, 91st Cong. (1969).

leadership, policies, and position substantially contributing and supporting rather than hindering its foreign policy objectives.

APPENDIX

DEFINITIONS BY THE DEPARTMENT OF COMMERCE OF THE ACCOUNTS IN THE BALANCE OF PAYMENTS

Source: U.S., Department of Commerce, _Dictionary of Economic and Statistical Terms_ (Washington, D.C.: Government Printing Office, August, 1969), pp. 21-43.

TERM	DEFINITION
Exports of Goods and Services (Line 1)	Exports of goods and services represent the sum of all credits from merchandise exports, transfers of goods and services under military sales contracts and military grants, transportation and travel receipts, fees and royalties from direct investments, other private and U.S. Government service receipts, and income on U.S. investments abroad. By far the largest component of this category is the merchandise export account. This includes all goods sold, given away, or otherwise transferred from the United States to foreign areas. Line 1 is the sum of lines 3 through 13.
Exports of Goods and Services, Excluding Transfers from Military Grants (Line 2)	A total for exports of goods and services excluding transfers under military grants is calculated because these transfers are considered to be of a special type of transaction that may be separated out in an analytical evaluation of the balance of payments. Exports under military grants are also omitted from exports of goods and services in the GNP account but are reflected there in Government expenditures. The entry for exports under line 5, Military grants (a credit) is exactly offset by line 28, Transfers under military grants, net (a debit).
Merchandise, Adjusted, Excluding Military (Line 3)	The merchandise export account is based primarily on the official export statistics of the Census Bureau but with the addition of various adjustments to bring them into conformity with balance-of-payments concepts. This account includes, with certain exceptions, all goods which are sold, given away, or otherwise transferred from the U.S. to foreign ownership. Since foreign branches and subsidiaries of American companies are considered as foreign rather than as domestic businesses, shipments to them are treated as merchandise exports. Export shipments are valued at the time and place of export--that is, at actual selling price, or at cost if not sold, including inland freight; insurance, and other charges to the place of export. This export valuation concept is referred to as exports f.a.s. (free alongside ship). All shipments by the Department of Defense (D.O.D.) of grant-aid military equipment and supplies under the Mutual Security Program and transfers under military sales contracts are excluded from the merchandise export data. Shipments of goods to our own armed forces and diplomatic missions abroad are not considered to be foreign transactions and are excluded both from the Census Bureau's export statistics and from the balance-of-payments compilations. Thus, the overall balance-of-payments effects of D.O.D. foreign transactions are separated from the more generally defined merchandise trade trends. See also Merchandise exports, excluding military aid shipments, p. 56.

Transfers Under Military Sales Contracts
(Line 4)

Transfers under military sales contracts are transfers to foreign governments or companies that are arranged directly with the Department of Defense, rather than a private business firm in the United States. For example, an export shipment of military aircraft and equipment to a NATO country is included in line 4 only if the order was placed through the D.O.D. The transfers include both goods and services and can be made from the U.S. as well as from overseas military bases.

Transfers Under Military Grants, Net
(Line 5)

Transfers under military grants consist of the value of the actual shipments of goods and the rendering of services to foreign governments. It should be noted that the shipment of goods need not necessarily be in the form of an export from the United States. It can represent the transfer of goods from U.S. military stocks located abroad to foreign recipient countries.

Under the provisions of the Defense Department's military grant program, a wide range of military goods and services are transferred to allies who cannot afford to finance their national defense programs entirely from their own resources. The aim of this program is to strengthen the national defense of those countries which are considered essential to our own defense. Greece, Turkey, and South Korea, to mention a few, are countries that have received grants under the program.

In the balance of payments, military grants are recorded on a net basis—that is, reverse grants and returns on grants are netted out.

Inasmuch as military grants do not require reimbursement from abroad, an identical offsetting entry—a debit figure—is made in line 28.

Transportation
(Line 6)

Transportation receipts arise principally from the following types of transactions:

- Freight revenues of U.S. operated ocean and air carriers (also rail and pipeline) for the carriage of U.S. exports from a U.S. port of exit to a foreign port of entry. This is based on the fact that the export value of the merchandise is on an f.a.s. basis—that is, it includes U.S. inland freight charges from the point of origin to the point of export. The carriage of U.S. exports by a foreign-operated carrier is not a balance-of-payments transaction because the foreign importer of the goods pays a foreign carrier and there is, therefore, no U.S. international receipt involved. The convention adopted in the balance of payments is that in any merchandise trade transaction, the importer ultimately pays the freight.
- Freight revenues of U.S. operated carriers for the carriage of foreign freight (and passengers) from one foreign point to another foreign point.
- International travel fare receipts of U.S. ocean and air carriers from foreign travelers to the United States, covering their passage to and or from the United States.

TERM	DEFINITION
Transportation (Line 6) (Cont'd)	• Port expenditure receipts, representing payments for goods and services purchased in the U.S. by foreign transportation companies. The flow in the opposite direction appears in line 17, Transportation.
Travel (Line 7)	Receipts associated with travel by foreign residents in the U.S. are recorded in the balance of payments as exports of goods and services. Expenditures made in the U.S. by foreigners for lodging, food, amusements, gifts, and other purchases constitute a receipt (a credit) in the travel account. International travel fares paid to U.S. airlines by foreigners traveling to the United States are not included in this line but are included instead in line 6, Transportation. The flow in the opposite direction—expenditures of U.S. residents traveling abroad—appears in line 18, Travel.
Fees and Royalties from Direct Investments (Line 8)	Fees and royalties are reported by companies with direct investments abroad. They represent income received by U.S. parent companies from their foreign affiliates for patent royalties, licensing fees, rentals, management services, other home office charges, and research and development.
Other Private Services (Line 9)	Other private services represent receipts from unaffiliated foreign entities for a variety of miscellaneous services. They include, in addition to royalties and fees described in line 8, such service transactions as the foreign contract operations of U.S. engineering, contracting, and consulting firms; international cable, radio, and telephone operations of U.S. communications companies; international reinsurance transactions; and rental receipts from the showing of U.S. motion pictures in foreign countries. Also included in this category are receipts obtained from the operation and maintenance expenses of foreign government embassies and international organizations (e.g., the United Nations) in the United States. These transactions are in this line rather than in line 10, other U.S. Government services, because they are received by the U.S. private sector. The flow in the opposite direction appears in line 19, Private payments for other services.
Receipts from Other U.S. Government Services (Line 10)	Receipts from other U.S. Government services relate mostly to services provided under nonmilitary aid programs. They also include income earned by American embassies in the processing of visas and other consular activities. A large part of the income is derived through the operation of the Panama Canal. The flow in the opposite direction appears in line 20, U.S. Government payments for other services.

Income on U.S. Investments Abroad: Direct Investments
(Line 11)

Income on U.S. investments abroad consists primarily of dividends, interest, and branch profits paid or credited by foreign subsidiaries and branches to their parent companies in the United States. Income in the form of fees, royalties, and other service charges received by U.S. direct investment companies from their foreign affiliates is included in line 8, Fees and royalties from direct investments.

The flow in the opposite direction appears in line 21, Income on foreign investments in the United States: private payments.

Income on U.S. Investments Abroad: Other Private Assets
(Line 12)

Other private assets consist of interest income derived by individuals and private banks and other organizations in the U.S. from holdings of foreign bonds, bank deposits, and other claims. They also include dividends on the holdings of U.S. residents of foreign equity shares. The income received is recorded net of foreign taxes.

Income on U.S. Government Investments Abroad: U.S. Government Assets
(Line 13)

Interest income received by the U.S. Government on long- and short-term loans outstanding to the rest of the world is reported in line 13. An example is the interest on long-term project and development loans made by the Agency for International Development to the developing nations of the world. Interest earned on Export-Import Bank loans and from PL 480 counterpart fund deposits in commercial banks abroad is included. Also included is interest received on U.S. holdings of convertible foreign currencies.

The flow in the opposite direction appears in line 22, Income on foreign investments in the United States: U.S. Government payments.

Imports of Goods and Services
(Line 14)

Imports of goods and services represent the sum of all payments for merchandise imports, military expenditures, transportation and travel costs, other private and U.S. Government services, and income and service payments to foreign parent companies by their affiliates operating in the United States.

By far the largest component of this category is merchandise imports, which includes all goods bought or otherwise transferred from a foreign country to the United States. However, military and foreign travel expenditures, international transportation payments, and income payments on foreign investments in the U.S. are also of considerable significance.

Military expenditures are those payments abroad that are connected with our military programs in foreign areas.

Expenditures for travel by Americans abroad include payments closely connected with travel such as lodging, food, amusements, gifts, and other purchases.

Imports of Goods and Services
(Line 14) (Cont'd)

International transportation payments consist principally of payments to foreign carriers of U.S. imports, payments for charter hire of foreign flag vessels, and travel fares paid to foreign international airlines by U.S. residents traveling to and from abroad.

Line 14 is the sum of lines 15 through 22.

See also Exports of goods and services, p. 27 .

Merchandise, Adjusted, Excluding Military
(Line 15)

The merchandise import account, like the merchandise export account, is based primarily on the official trade statistics of the Census Bureau. A number of adjustments are applied to the Census figures to bring them into conformity with balance of payments concepts. This account includes, with certain exceptions, all nonmilitary goods which are transferred from a foreign country to the United States.

Imports of military goods--including uranium--are excluded from this account because they are included elsewhere, under line 16, Military expenditures.

Goods which enter Customs bonded warehouses are included as well as goods released from Customs custody immediately upon arrival. Nonmilitary Government imports are also entered in this account. In addition, since foreign branches and subsidiaries of American companies are considered foreign rather than domestic, goods shipped from these branches and subsidiaries are treated as merchandise imports.

Merchandise imports are, in general, priced in the accounts at the wholesale market value in the country in which they are produced and, therefore, exclude United States import duties, ocean freight, and marine insurance. In general, this approximates an f.o.b. (free on board) exporting country basis. More specifically, it is a price determined in accordance with statutory regulations of the Bureau of Customs and forms the basis for the calculation of ad valorem import duties. It is not necessarily the actual price at which the goods were purchased.

See also General imports, p. 52 .

Military Expenditures
(Line 16)

Department of Defense (D.O.D.) expenditures abroad are expenditures connected with our military programs in foreign areas. Included in this line are D.O.D. purchases of goods and services in foreign countries. Services include direct labor or contract expenses paid to U.S. subsidiaries operating abroad (a foreign company in the balance-of-payments definitions) as well as to foreign business firms. Also included is that portion of military personnel pay disbursements spent outside of the United States or outside United States installations abroad (e.g., post exchanges, commissaries). Note that expenditures for supplies, equipment, vehicles, aircraft, for example, purchased in the U.S. and then shipped to U.S. armed forces installations abroad are not balance-of-payments transactions, nor are they included in export statistics of the Census Bureau.

The flow in the opposite direction appears in line 4, Transfers under military sales contracts.

Transportation
(Line 17)

Transportation payments reflect principally the following types of transactions:

- Freight payments to foreign-operated ocean, air, rail, and pipeline carriers for the carriage of U.S. imports from the foreign market to a U.S. port of entry. U.S. trade statistics value merchandise imports on a f.o.b. (free on board) foreign market basis. The carriage of U.S. imports by U.S. operated carriers is not a balance-of-payments transaction because the U.S. importer pays a U.S. carrier and there is, therefore, no international payment involved.
- International travel fare payments to foreign ocean and air carriers by U.S. residents traveling between the U.S. and foreign countries.
- Port expenditure payments, representing purchases of goods and services in foreign countries by U.S. operators and transportation companies.
- Charter hire payments made to foreign owners of vessels by U.S. resident firms operating these vessels on a rental basis.

The flow in the opposite direction appears in line 6, Transportation.

Travel
(Line 18)

Expenditures in foreign countries associated with travel abroad by American residents are recorded in the balance of payments as imports of goods and services. Expenditures of U.S. residents traveling in foreign countries for food, lodging, amusements, and gifts constitute a payment in the travel account.

There are several notable exceptions in the treatment of some expenditure items in the travel account. Expenditures by U.S. Government employees stationed abroad are not included in the travel account, but rather in line 20, Other U.S. Government services and in line 16, Military expenditures. Also, private U.S. citizens living abroad are considered to be foreign residents and their expenditures, therefore, are excluded from this account.

In addition, travel fares paid to foreign-owned international airlines by U.S. residents traveling from the United States to foreign destinations are omitted from the travel account but are included instead in line 17.

The flow in the opposite direction appears in line 7, Travel.

Private Payments for Other Services
(Line 19)

This account represents U.S. payments to foreign entities for a variety of miscellaneous services. It includes royalties, fees, and other service payments made to foreign parent companies by their affiliates located in the United States.

Among the major types of miscellaneous service transactions (other than between affiliates) included in this account are: royalties and licensing fees; international cable, radio, and telephone charges; insurance and reinsurance; film rental payments for foreign films shown in the United States; and expenditures of U.S. filmmakers in foreign countries. Also in-

TERM	DEFINITION
Private Payments for Other Services (Line 19) (Cont'd)	cluded are wage remittances to their home countries of foreign migrant laborers working in the United States. The flow in the opposite direction appears in line 9, Other private services.
U.S. Government Payments for Other Services (Line 20)	U.S. Government payments for other services include a wide range of activities. Examples include salaries and allowances to State Department employees assigned to the embassies throughout the world, rental payments for embassy buildings, and subscriptions to international organizations such as the United Nations. The flow in the opposite direction appears in line 10, Receipts from other U.S. Government services.
Income on Foreign Investments in the United States: Private Payments (Line 21)	Income on foreign investments in the United States (private payments) includes branch profits, dividends, and interest paid by U.S. affiliates of foreign companies. It also includes interest and dividend payments to foreign holders of U.S. companies' bonds and stocks, and interest on other debt including liquid liabilities by private banks to foreigners. The flow in the opposite direction appears in line 11, Income on U.S. investments abroad: direct investments.
Income on Foreign Investments in the U.S.: U.S. Government Payments (Line 22)	United States Government interest payments to foreigners who hold Federal securities are included in line 22. The major portion of these payments goes to foreign governments which hold the obligations as part of their monetary reserves. This entry also includes interest on foreign deposits in the U.S. Treasury —deposits that are used primarily to facilitate payment for goods and services received under Department of Defense contracts. The flow in the opposite direction appears in line 13, Income on U.S. Government investments abroad: U.S. Government assets.
Balance on Goods and Services (Line 23) **Excluding Transfers Under Military Grants** (Line 24)	The balance on goods and services is the algebraic sum of exports and imports of goods and services. It includes merchandise trade (exports and imports of goods) and the so-called "invisible" items—shipping charges, income on investments, rents, royalties, payments for insurance, donations, and travel. Line 24, Balance on goods and services, excluding transfers under military grants, is given in order to show the relationship between flows of goods and services and capital plus reserve movements. Transfers made under military grants are accounted for in two exactly offsetting entries—lines 5 and 28 and, therefore, have no net effect on the other flows in the balance of payments. A surplus balance on goods and services is compatible with an export of capital or an accumulation of foreign exchange

TERM	DEFINITION
Balance on Goods and Services (Line 23) **Excluding Transfers Under Military Grants** (Line 24) (Cont'd)	reserves. On the other hand, a deficit balance on goods and services must be financed by an import of capital or a drawing down of foreign exchange reserves. The balance on goods and services, excluding transfers under military grants, corresponds to the net exports of goods and services in the National Income and Product Accounts (line 35 in Table A, p. 7).
Unilateral Transfers, Net; Transfers to Foreigners (Line 25)	Net unilateral transfers are those for which no goods, services, or payments are received in return. They encompass an extremely wide range of activity by private citizens and institutions and by the Federal Government. The private unilateral transfers include all noncommercial payments such as institutional gifts of cash and goods associated with foreign relief work and personal remittances to foreigners. There are three major kinds of government transfers abroad: • Transfers under the Department of Defense military grant program. • Nonmilitary grants of goods or money to the developing nations of the world by the U.S. Agency for International Development. • U.S. Government transfers in the form of social security, civil service, veterans' and railroad retirement pension payments to Americans residing abroad.
Unilateral Transfers; Net; Transfers to Foreigners: Excluding Military Grants (Line 26)	A total for unilateral transfers, excluding military grants, is included to provide figures consistent with line 2, Exports of goods and services excluding military grant transfers, and line 24, Balance on goods and services excluding military grant transfers. Transfers under the military grant program are accounted for in two exactly offsetting entries, lines 5 and 28, and, therefore, have no net effect on the balance-of-payments statistics. Line 25 is the sum of lines 27 through 30.
Private Remittances (Line 27)	Private remittances represent transfers or transmissions of cash and goods by individuals and by charitable and nonprofit institutions to individuals or groups residing abroad. Personal remittances include all noncommercial transfers of funds abroad by means of customary bank drafts and money orders. The remittances include gifts, inheritances, and tax payments. In addition to these cash remittances, an estimate is included for the value of goods forwarded abroad as gifts. In the case of gifts mailed abroad, an equal export entry (an offsetting credit) is made to the merchandise account. Institutional unilateral transfers of cash and goods arise from foreign relief work in the developing nations of the world. Approximately 135 religious and charitable agencies are currently reporting such transfers.

TERM	DEFINITION
Private Remittances (Line 27) (Cont'd)	Included also are receipts by U.S. residents—principally German and Austrian—of indemnifications of losses sustained as a result of actions by the German Government prior to and during World War II.
Military Grants of Goods and Services (Line 28)	The Defense Department's military grant program provides goods and services to the military organizations of allied countries that cannot afford to finance their national defense programs entirely from their own resources. Under the program, the U.S. does not require reimbursement from abroad for the shipment of these goods and the rendering of these services to foreign governments. Unilateral transfers for military grants of goods and services comprise simply the identical offsetting entry of line 5 in the Balance of Payments Accounts, and represent no actual financial transactions.
Other U.S. Government Grants (Line 29)	For balance of payments purposes, Government grants are defined as transfers of resources (goods, services, and cash) for which no payment is expected, or for which repayment terms have not yet been determined. More than half of the nonmilitary grant programs are administered by the Agency for International Development (AID). The actual goods (for instance, machinery for an irrigation project) and services (for instance, transportation or technical assistance by an agricultural expert) financed by the grant are recorded in lines 3, 6, and 10, respectively, in the balance of payments. But because an offsetting entry for these resources is required and because no payment is received, a debit for them is created and recorded in line 29, Other U.S. Government grants under unilateral transfers.
U.S. Government Pensions and Other Transfers (Line 30)	U.S. Government pensions consist of payments of social security benefits and civil service, veterans, and railroad retirement pensions to Americans residing abroad, or to foreigners entitled to such payments. These payments constitute approximately 80 percent of the total amount of this category. Other transfer payments abroad for U.S. educational and cultural exchange programs which are administered by the Department of State are also included here. A small amount of the transfers included in this account supports research at foreign universities.
Balance on Goods, Services, and Unilateral Transfers (Line 31)	The balance on goods, services, and unilateral transfers represents the balance on current account which—except for errors and omissions—must be counterbalanced by capital movements, a change in official reserves, or both. All transactions involving transfers of goods and services are included in the current account, with the exception of monetary gold transactions, which are recorded in line 47, as a component part of U.S. official reserve assets.

Balance on Goods, Services, and Unilateral Transfers
(Line 31) (Cont'd)

The balance on goods, services, and unilateral transfers is net foreign investment by the United States; see discussion in Introduction to Part II.

Transactions in U.S. Private Assets, Net
(Line 32)

Transactions in U.S. private assets include acquisitions and sales by U.S. private residents of assets held abroad. These transactions are placed in four principal categories:

- Direct investments abroad by U.S. corporations
- Purchases by U.S. residents of newly issued and outstanding foreign securities
- Long-term and short-term claims on foreigners reported by U.S. banks
- Long-term and short-term claims (not included in direct investments) reported by U.S. residents other than banks.

Line 32 is the sum of lines 33 through 40.

Direct Investments
(Line 33)

U.S. direct investment abroad is the flow of U.S. capital into foreign business enterprise in which U.S. residents have significant control. Hence the capital movements are deemed to be foreign extensions of the management interests of the parent corporation. The distinction between long-term investments in equity securities and direct investment is made on the basis of ownership. Investment is considered direct when the U.S. individual or company owns more than 10 percent of the foreign concern.

The flows included in the balance-of-payments report are:

- Short- and long-term funds invested by the U.S. parent corporation
- Transfers by the U.S. parent corporation to the foreign affiliate (or to foreign residents as compensation for the acquisition of equity interests) of funds that had been borrowed abroad by the U.S. parent or its U.S. affiliates.

The flows not included in the balance-of-payments report (although they affect the net worth of the investment) are:

- Depreciation allowances and reinvested earnings of foreign subsidiaries
- Changes in foreign assets that result from political actions or natural causes abroad.

These latter transactions involve no transfer of funds between the U.S. parent and its foreign affiliate.

Portfolio capital flows are recorded in lines 34 and 36 of the balance of payments. The flow in the opposite direction appears in line 51, Direct investments.

TERM	DEFINITION
Foreign Securities Newly Issued in the United States (Line 34) **Redemptions** (Line 35) **Other Transactions in Foreign Securities** (Line 36)	All purchases and sales of foreign securities in U.S. markets reported by U.S. banks, brokers, dealers, or individuals from or to the account of a foreign seller or buyer are included in the U.S. balance of payments. All security transactions represent the amounts of dollars paid to or received from the foreign seller or buyer, after deducting discounts and commissions. In the balance of payments these transactions are shown in three separate lines–namely, new issues, redemptions, and other transactions. Purchases of newly issued foreign securities (a debit) are recorded in line 34, while the net result of other transactions (either purchases–a debit–or sales–a credit) in outstanding foreign securities is recorded in line 36. When a foreign security originally issued in the U.S. is redeemed, a credit (a dollar inflow) is recorded in line 35. The flow in the opposite direction appears in line 52, U.S. securities other than treasury issues.
Claims Reported by U.S. Banks: Long-Term (Line 37)	Long-term claims reported by U.S. banks represent commercial bank loans to foreigners. These loans may go to private business, individuals, or foreign governments. A large part of these comprise loans for foreign corporations, including loans to finance ship mortgages, U.S. exports, plant expansion, and to refinance debts outstanding. A loan is considered long-term if its repayment schedule is for more than one year. The flow in the opposite direction appears in line 53, Long-term liabilities reported by U.S. banks.
Claims Reported by U.S. Banks: Short-Term (Line 38)	Short-term claims include loans extended to foreigners with a maturity of less than one year. Loans to foreign banks for the purpose of financing general trade transactions on foreign accounts and short-term bank claims in foreign currencies that represent correspondent balances held in the bank's own account abroad are included. Nonbank claims such as outstanding collections held in the bank's custody or short-term investments in foreign money market assets are also included.
Claims Reported by U.S. Residents Other Than Banks: Long-Term (Line 39)	Long-term claims reported by U.S. residents other than banks are, mainly, those reported by private business firms resulting from their export transactions. These claims assume various forms. A common example is "supplier's credit." This is the long-term financing extended to a foreigner by a U.S. corporation in order that it may sell its product abroad. Long-term loans made to foreigners by insurance companies are also included.

Claims Reported by U.S. Residents Other Than Banks: Short-Term
(Line 40)

Short-term claims reported by U.S. residents other than banks include those reported by U.S. brokerage houses. These claims may be in the form of a cash account held by the broker. Also included are other short-term financial assets held abroad such as the unused proceeds of loan flotations by U.S. corporations in foreign capital markets.

Transactions in U.S. Government Assets, Excluding Official Reserve Assets, Net
(Line 41)

Transactions in U.S. Government assets, excluding official reserve assets, include loans and credit extensions of the Federal Government to foreign countries, the U.S. Government's holdings of foreign currencies abroad, and scheduled and nonscheduled repayments resulting from these loans. These transactions include long-term capital assistance loans provided by the U.S. Agency for International Development to the developing countries of the world, loans provided under PL 480 by the Export-Import Bank, and capital subscriptions to international lending organizations.

These capital outflows increase the net U.S. foreign claims on the countries receiving the loans, or on international organizations.

Line 41 is the sum of lines 42 through 45.

Loans and Other Long-Term Assets
(Line 42)

A part of total transactions in U.S. Government assets, this account includes the flow of capital abroad resulting from all loans and credits with an original maturity of more than one year made by the Federal Government to foreign countries. Most of these credits finance U.S. exports of goods and services.

In 1968 long-term dollar loans under the defense and economic development programs administered by the Agency for International Development (AID) accounted for less than one-third of total U.S. Government long-term foreign lending; Export-Import Bank dollar credits accounted for over 40 percent; and dollar and foreign currency loans extended under Public Law 480, about 25 percent. The remaining long-term credit transactions include principally credits related to the sale of military equipment.

Foreign Currencies and Other Assets
(Line 43)

The U.S. Government's holdings of foreign currencies included in this account consist of changes in holdings of Indian rupees, Chilean escudos, and other "soft" currencies. Changes in convertible or "hard" currencies—dollars, marks, lire—are included in line 48. A net increase of soft currencies results primarily from the sale of U.S. surplus agricultural products in exchange for local currency. Loan principal and interest repayments made by a foreign government in its own currency are also included in this account.

In addition to changes in its foreign currency holdings resulting from these sources, the U.S. also deliberately purchases foreign currencies as required to meet operational needs

Foreign Currencies and Other Assets
(Line 43) (Cont'd)

abroad such as the day-to-day expenses of an American embassy. Inasmuch as these currency holdings represent assets owned by the U.S. Government, their changes must be reflected in the balance of payments.

Repayments on Credits: Scheduled and Nonscheduled
(Lines 44 and 45)

Repayments on credits are the amortization of loans resulting from U.S. Government capital assistance programs to foreign countries. The repayment period on these loans is relatively long and the interest rate is small.

Scheduled repayments of principal are recorded in line 44; the accompanying interest repayment is recorded in income on U.S. Government assets abroad (line 13). In recent years these repayments have reached almost $1 billion annually.

Nonscheduled repayments (line 45) are mainly prepayments by foreign governments on their outstanding loans. Also included are sell-offs of outstanding Export-Import Bank loans.

Transactions in U.S. Official Reserve Assets, Net
(Line 46)

Transactions in U.S. official reserve assets consist of three items: (1) changes in U.S. gold reserve holdings, (2) changes in the U.S. holdings of convertible foreign currencies, and (3) changes in the U.S. gold tranche position in the International Monetary Fund (IMF) which consists of the virtually automatic drawing rights of the United States from the IMF. This item indicates whether the U.S. is gaining or losing international reserves.

When the changes in total U.S. liabilities to foreign official monetary institutions—liabilities that represent reserve assets of those institutions—are added algebraically to the change in official reserve assets, the result is the balance-of-payments surplus or deficit on an official reserve transactions basis. (See lines 13-20 in Table 3 contained in the Introduction to this part, p. 24.)

Line 46 is the sum of lines 47 through 49.

Gold
(Line 47)

The U.S. Treasury buys gold from and sells gold to foreign governments, central banks, and international financial organizations. These official transactions take place at the established rate of $35 per fine troy ounce (plus or minus handling charges). By international agreement the U.S. Treasury and other leading central banks now buy gold from and sell gold to only official monetary agencies and limit their gold transactions to the stocks held by official institutions. Thus, variations in the U.S. monetary gold stock occur now only as a result of international transactions between the U.S. and foreign monetary authorities. Private buyers—including industry and the arts—must purchase gold from private sellers, including primary producers, at whatever price prevails in this market. This is known as the two-tier gold system.

The Treasury conducts its gold transactions with foreign monetary authorities through a working balance called the Exchange

TERM	DEFINITION
Gold (Line 47) (Cont'd)	Stabilization Fund, which is not included in the figures reported for the Treasury's gold stock. The Federal Reserve Bank of New York acts as the Fund's fiscal agent in these transactions.
Convertible Currencies (Line 48)	Convertible currencies include the U.S. Treasury and Federal Reserve holdings of foreign currencies that are counted as part of official U.S. reserve assets. Changes in U.S. holdings of foreign currencies result primarily from reciprocal currency arrangements. The U.S. has reciprocal currency arrangements under which the U.S. may exchange dollars for other currencies under certain conditions and up to agreed upon limits with a number of countries and the Bank for International Settlements. After a stated period of time, the transaction may be reversed. These arrangements are commonly referred to as "swap arrangements." Their purpose is to provide a mechanism to absorb the initial shock of unusually heavy movements of funds in international exchanges, thereby permitting gold to play a much less active role in the settlement of temporary imbalances. While a swap agreement does not affect the surplus or deficit in the balance of payments, it allows the U.S. (or other participating country) to finance a deficit for a short period without reducing its gold and foreign exchange assets.
Gold Tranche Position in IMF (Line 49)	The gold tranche position in the IMF represents the amount that the United States can draw (borrow) in foreign currencies virtually automatically from the International Monetary Fund if such borrowings are needed to finance a balance-of-payments deficit. The gold tranche itself is determined by the U.S. quota paid in gold minus the holdings of dollars by the IMF in excess of the dollar portion of the U.S. quota. Transactions of the IMF in a member country's currency are transactions in monetary reserves. When the Fund sells dollars to other countries to enable them to finance their international payments, the net position of the U.S. in the Fund is improved. An improvement in the net position in the gold tranche is similar to an increase in the reserve assets of the United States. On the other hand, when the U.S. buys other currencies from the Fund, or when other countries use dollars to meet obligations to the Fund, the net position of the U.S. in the Fund is reduced.
Transactions in Foreign Assets in the United States, Net (Line 50)	Transactions in foreign assets in the United States include a wide range of private and government international transactions. These capital flows are divided into four categories: • Foreign direct investment in the United States for the purpose of acquiring equity interests in U.S. enterprises or expanding foreign assets in foreign branches and subsidiaries in the United States • Foreign purchases and sales of U.S. securities other than Treasury issues–mainly common stock and bonds

Transactions in Foreign Assets in the United States, Net
(Line 50) (Cont'd)

- Long-term deposits by foreigners in U.S. commercial banks
- U.S. Treasury bonds, notes, deposits, and money market paper held in the United States.

Line 50 is the sum of lines 51 through 59.

Direct Investments
(Line 51)

Foreign direct investment in the U.S. is the flow of foreign capital into U.S. business enterprise in which foreign residents have significant control. Hence, the capital movements are regarded as foreign extensions of the management interests of the parent corporation. The distinction between long-term investment in equity securities and foreign direct investment in the U.S. is made on the basis of ownership. Investment is considered direct when the foreign individual or company owns more than 25 percent of the U.S. concern.

The flows included in the balance-of-payments report are:

- Short- and long-term funds invested by the foreign parent corporation
- Transfers by the foreign corporation to the U.S. affiliate (or to U.S. residents as compensation for the acquisition of equity interests) of funds that had been borrowed in the U.S. by the foreign parent or its foreign affiliates.

The flows not included in the balance-of-payments report (although they affect the net worth of the investment) are:

- Depreciation allowances and reinvested earnings of U.S. subsidiaries
- Changes in U.S. assets that result from political actions or natural causes in the United States.

These latter transactions involve no transfer of funds between the foreign parent and its U.S. affiliates.

The flow in the opposite direction appears in line 33, Direct investments.

U.S. Securities Other Than Treasury Issues
(Line 52)

This line includes data on foreign purchases and sales of U.S. stocks and bonds. Treasury issues are excluded here, but bonds issued by U.S. Government agencies and by local governments are included.

Since the growth of European capital markets, a large part of these foreign purchases have consisted of U.S. corporate issues for the purpose of financing U.S. direct investments in their foreign affiliates. If the capital raised by these U.S. corporations (often referred to as Delaware corporations) is not used immediately and the money is deposited abroad in a bank, a debit entry is made in line 40, Claims reported by U.S. residents other than banks.

The flow in the opposite direction appears in lines 34, Foreign securities newly issued in the United States, 35, Redemptions, and 36, Other transactions in foreign securities.

TERM	DEFINITION
Long-Term Liabilities Reported by U.S. Banks (Line 53)	Long-term liabilities reported by U.S. banks include long-term deposits—in excess of one year—by foreigners in U.S. banks, mainly by foreign official or international agencies. Some of these liabilities consist of deposits used to finance U.S. imports, plant expansion, and other financial transactions which would involve U.S. banking services, such as a foreign government's line of credit to a U.S. bank. The flow in the opposite direction appears in line 37, Claims reported by U.S. banks: long-term.
Other Liabilities Reported by U.S. Private Residents Other Than Banks: Long-Term (Line 54)	Other long-term liabilities reported by U.S. private residents other than banks represent indebtedness of U.S. corporations to foreigners. Long-term suppliers' credits incurred by U.S. businessmen from foreign suppliers are included in this item. The major portion of such indebtedness incurred in recent years represents loans obtained abroad to finance foreign direct investments.
Other Liabilities Reported by U.S. Private Residents Other Than Banks: Short-Term (Line 55)	Other short-term liabilities reported by U.S. private residents other than banks include funds owed by brokers to U.S. private residents and short-term suppliers' credits extended to foreign producers and short-term credits to meet domestic credit requirements or to finance foreign direct investments.
Nonmarketable Liabilities of U.S. Government, Including Medium-Term Securities Payable Prior to Maturity Only Under Special Conditions: Associated With Specific Transactions (Line 56)	United States Government liabilities associated with specific transactions are mainly advance payments by foreign governments to special subscription securities issued to the Department of Defense in anticipation of future delivery of military procurement shipments. Other transactions included are the International Development Association, the Inter-American Development Bank, and the United Nations. These latter payments are in the form of noninterest-bearing, nonmarketable securities issued in lieu of cash payments. In the past, these special securities were issued to these international institutions until such time as they were spent.
Nonmarketable Liabilities of U.S. Government, Including Medium-Term Securities Payable Prior to Maturity Only Under Special Conditions: Other Medium-Term Securities (Line 57)	Other medium-term securities include foreign holdings of nonmarketable, medium-term U.S. Government securities, payable before maturity only under special conditions. Examples of these are nonconvertible "Roosa Bonds" issued by the Treasury, and Certificates of Participation representing Export-Import Bank loans sold mainly to foreign governments and central banks.

U.S. Treasury Marketable or Convertible Bonds and Notes
(Line 58)
Deposits and Money Market Paper Held in the United States
(Line 59)

The U.S. normally owes and is owed money internationally. The balance of payments must adjust continuously under the influence of these financial conditions.

When a foreign country earns more than it spends in the U.S., there is an increase in the foreign claims on the United States. This increase may be in the form of a rise in cash balances deposited in a bank in the U.S., or it may be invested in short-term liquid money market paper such as Treasury bills, negotiable certificates of deposit, or bankers' acceptances.

On the other hand, if a foreign country spends more than it earns in the U.S., there is a decrease in cash balances which must be reconciled by drawing down the foreign country's commercial bank deposits or by selling or redeeming the foreigner's holdings of money market paper or other liquid assets.

Lines 58 and 59 are included in the balance of payments to reflect the adjustments in the foreign holdings of U.S. liquid liabilities. The buying and selling of U.S. Treasury securities—with an original maturity of one year or more—are shown in line 58, while the changes in U.S. short-term liabilities reported by U.S. banks—adjustments in bank deposits and the investing or disinvesting in money market paper including short-term Government securities held in custody by the banks for foreign residents–are reflected in line 59.

In combination, the financial transactions reflected in these two lines are very important in the overall balance of payments. The balance on liquidity basis is measured by the algebraic sum of the changes in U.S. official reserve assets (line 46) and liquid liabilities to all foreigners (lines 58 and 59). These two accounts measure the deficit or surplus in the overall balance of payments on a liquidity basis. (See Lines 1-12, Table 3, p. 24.)

The interaction between lines 58 and 59 and 46 is important. Frequently, foreign holdings of U.S. Treasury securities are sold in private foreign markets to official government agencies, rather than sold or liquidated in the United States. Foreign monetary authorities regard these securities as their own central bank reserves, which may be redeemed in the United States for gold. Thus, the sale of U.S. Treasury securities to foreigners can lead to an increase of U.S. official liabilities to foreign official holders and subsequently to a decline in U.S. official reserve assets.

Net Errors and Omissions
(Line 60)

Net errors and omissions is the statistical discrepancy between total recorded entries under receipts and total recorded entries under payments. It is entered as either net receipts or net payments, as needed in order to fulfill the accounting principle that the sum of receipts and payments must balance. The source of the discrepancy cannot be identified with any precision.

Table 1.–U.S. International Transactions 1968 (Millions of dollars)

Line	(Credits +; debits –)	
1	Exports of goods and services	51,432
2	Excluding transfers under military grants	50,594
3	Merchandise, adjusted, excluding military	33,598
4	Transfers under military sales contracts	1,427
5	Transfers under military grants, net	838
6	Transportation	2,924
7	Travel	1,770
8	Fees and royalties from direct investments	1,279
9	Other private services	1,546
10	Other U.S. Government services	352
	Income on U. S. investments abroad:	
11	Direct investments	4,985
12	Other private assets	1,949
13	U.S. Government assets	765
14	Imports of goods and services	—48,078
15	Merchandise, adjusted, excluding military	—32,972
16	Military expenditures	—4,530
17	Transportation	—3,248
18	Travel	—3,022
19	Private payments for other services	—625
20	U.S. Government payments for other services	—749
	Income on foreign investments in the United States:	
21	Private payments	—2,231
22	U.S. Government payments	—702
23	Balance on goods and services (lines 1 and 14)	3,354
24	Excluding transfers under military grants (lines 2 and 14)	2,516
25	Unilateral transfers, net; transfers to foreigners (—)	—3,703
26	Excluding military grants	—2,865
27	Private remittances	—753
28	Military grants of goods and services	—838
29	Other U.S. Government grants	—1,706
30	U.S. Government pensions and other transfers	—406
31	Balance on goods, services, and unilateral transfers (lines 23 and 25, or 24 and 26)	—349
32	Transactions in U.S. private assets, net; increase in assets (—)	—5,157
33	Direct Investments	—3,025
34	Foreign securities newly issued in the United States	—1,659
35	Redemptions	495
36	Other transactions in foreign securities	—102
	Claims reported by U.S. banks:	
37	Long-term	358
38	Short-term	—89
	Claims reported by U.S. residents other than banks:	
39	Long-term	—174
40	Short-term	—960
41	Transactions in U.S. Government assets, excluding official reserve assets, net; increase in assets (—)	—2,249
42	Loans and other long-term assets	—3,713
43	Foreign currencies and other assets	72
	Repayments on credits:	
44	Scheduled	1,123
45	Nonscheduled (including sales of foreign obligations to foreigners)	269
46	Transactions in U.S. official reserve assets, net; increase in assets (—)	—880
47	Gold	1,173
48	Convertible currencies	—1,183
49	Gold tranche position in IMF	—870
50	Transactions in foreign assets in the United States, net; increase in foreign assets (U.S. liabilities) (+)	9,352
51	Direct investments	319
52	U.S. securities other than Treasury issues	4,360
53	Long-term liabilities reported by U.S. banks	590
	Other liabilities reported by U.S. private residents other than banks:	
54	Long-term	673
55	Short-term	750
	Nonmarketable liabilities of U.S. Government, including medium-term securities payable prior to maturity only under special conditions:	
56	Associated with specific transactions	—138
57	Other medium-term securities	2,010
58	U.S. Treasury marketable or convertible bonds and notes	—500
59	Deposits and money market paper held in the United States	1,287
60	Errors and omissions, net	—717

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